Bloomberg Philanthropies — EBF — IIF — Paulson Institute — SIFMA — UN Environment

MAINSTREAMING SUSTAINABLE FINANCE

A Briefing

KEY MESSAGES

- *Sustainable finance has leapt from 'niche' to mainstream with lightning speed. Continued decisive action, both at the policy and market levels, will contribute to maintain the momentum achieved.* Such action could include the pricing of climate-related risks, mobilizing finance, and ensuring that sound underlying policies with clear and harmonized definitions are used across jurisdictions.

- *Sustainable finance can provide ways to address income inequality and meet the basic needs for all people.* Through a combination of public policy mechanisms and financial innovation, policymakers should ensure that coherent climate and investment policies, along with effective fiscal reforms, are working together to facilitate a just transition to a low-carbon economy. Financial innovations such as social impact bonds and sustainability bonds can also play a crucial role.

- *Emerging markets around the world are beginning to view sustainable finance as an opportunity.* It can drive the innovation that leads to job creation and new industries. Multilateral development banks (MDBs) can help foster sustainability in emerging markets, particularly by levering private sector finance, but tensions exist – debt, transparency and capacity to name a few.

- *Implementation of the Task Force on Climate-related Financial Disclosures (TCFD) recommendations will be a critical step for the continued mainstreaming of sustainable finance*. Corporations and business leaders have many levers available to facilitate the worldwide uptake of these recommendations for a coherent, scalable disclosure framework for use by companies and financial institutions.

Sustainable finance has leapt from 'niche' to mainstream with lightning speed since the first Sustainable Finance Roundtable in the series convened in April 2016. Sustainable investment products have skyrocketed, green bond issuance has grown to more than US$160 billion, and the Sustainable Development Goals (SDGs) are providing an effective framework for pension funds, banks and the insurance industry around the world. Sustainable finance has become an established part of the G20 agenda, while national and regional action is taking off, with the adoption of sustainable finance plans by many emerging markets (such as China, Kenya and Nigeria), the European Union (EU), and others. By some counts, roughly 25% of global assets under management can be considered 'sustainable' (US$20 trillion). But this still falls short of the World Bank estimate of US$23 trillion in investments needed for energy efficiency and climate resiliency to meet the commitments of the Paris Agreement on climate change and the US$7 trillion in annual investments needed to achieve the SDGs.

To maintain the momentum on sustainable finance, Bloomberg Philanthropies, the European Banking Federation (EBF), the Institute of International Finance (IIF), the Paulson Institute, the Securities Industry and Financial Markets Association (SIFMA) and UN Environment co-hosted a roundtable in Washington, D.C. on 20 April 2018. The roundtable brought together senior policymakers and private financial sector leaders to share perspectives on the rapidly changing landscape for sustainable finance. They focused on: sustainable finance for reducing inequality; sustainable finance in emerging markets; and investor perspectives on impact investing, the integration of environmental, social and governance (ESG) strategies, and the implementation of the Task Force on Climate-related Financial Disclosures (TCFD) recommendations.

THE ROLE OF SUSTAINABLE FINANCE IN REDUCING INEQUALITY

Climate risk and environmental degradation disproportionately affect the world's poorest populations. More broadly, financing for sustainable development should help find ways to address income inequality and the provision of basic needs for all. But how do countries reconcile their need for economic development with their environmental and social goals? How can they increase their living standards while reducing carbon intensity? How can they achieve a two-degree climate scenario while addressing economic inequalities?

Without a clear global policy level commitment, the financial system will not pursue the changes needed for a sustainable economy. Many of the least developed countries lack even the most basic enabling investment conditions, leaving the financial sector to address many sustainability challenges on its own – if at all. While many risk-offsetting mechanisms have been developed to provide more sound investment conditions, the adoption of clear, transparent, just, and market-enabling policy commitments can alter this situation. The EU High-Level Expert Group on Sustainable Finance, for example, has provided a clear policy commitment on a regional level for how the financial sector can promote economic development while helping to meet international commitments such as the Paris Agreement on climate change, the SDGs and the Convention on Biological Diversity.

Sustainable finance can best address the distributional and structural issues through a combination of two broad levers: public policy mechanisms and financial innovation.

Public Policy Mechanisms

Sustainable finance should address not only specific financial products – who is being financed and how – but also the structural policies that can address income distribution. Financial markets should be examined through a lens of financial market design rather than just product innovation and targets. Structural policy reforms (*e.g.* pricing social and environmentally related risks, mandated climate-related disclosure) that examine and account for the unintended environmental consequences of current financial market regulation are essential for making capital more effective to achieve the objectives of international commitments. If financial markets are delivering unequal outcomes, then coherent climate and investment policies and effective fiscal reforms will need to work together to facilitate a just transition. Inequality should be addressed in the transition, as there are both winners and losers resulting from the changes in structural policies.

Transition processes often have a disproportional impact on the most vulnerable populations. Policymakers will need a clear understanding of the best practices for fostering the transition to a low-carbon economy, as well as an appreciation of the implications. There can be unintended consequences on the path toward integrating climate risk into financial decision-making, particularly the link between cost of capital and climate exposure in most climate-vulnerable countries.

Financial Innovation

Top-Down Innovation: This approach plays a critical role helping to shift the risk/return equation to promote sustainable finance through financial product innovation, risk diversification and capacity-building. Several examples have appeared in the last couple of years that can help financial markets address inequalities:

- *Multilateral Investment Guarantee Agency (MIGA).* At a government level, MIGA promotes foreign direct investment in developing countries through investment guarantees that de-risk investments against different types of political related risks.
- *Social bonds and sustainability bonds* have raised more than US$3 billion. For example, the International Finance Facility for Immunisation (IFFIm) issued a vaccine bond, converting long-term vaccination related pledges from donor governments into immediate cash resources.
- *Social impact bonds (pay for performance bonds)* channel private capital into interventions that were traditionally funded by taxpayers. Private capital coming into these projects can measure the performance outcomes of social interventions, and could be scaled up for other interventions.
- *Digital finance* has brought structural challenges to the financial industry through the emergence of new technologies such as blockchain and peer-to-peer lending, which facilitate financial institution disintermediation. New digital technologies have allowed the financial industry to tackle other sustainability-related problems, such as energy access, more effectively.

Bottom-up innovation: Top-down market-driven approaches can limit the conversation about how people can participate in driving the uptake of sustainable finance. Experience from Ant Financial showcases a market-driven approach where mobile technology can facilitate both financial inclusion and, through the participation in the Ant Forest programme, people can contribute to greening the environment. They can plant virtual trees based on points earned through reducing their own carbon footprint, which is tracked through their online purchases. Consumer decisions are translated into virtual trees due to green behaviour. In addition, 'gamification' can create social pressure, since friends can 'steal' points for use on their own trees. The product was launched in 2016 and has since been used by more the 300 million people, making it the largest consumer side carbon-related mobile application.

SUSTAINABLE FINANCE IN EMERGING MARKETS

As emerging market policymakers chart a course towards sustainable development, domestic financial institutions, as well as global banks and investors, are working to integrate sustainability issues into their strategy and operations across emerging economies. But emerging markets face many unique and urgent challenges, particularly debt. In the Caribbean, recent hurricane relief efforts generated several proposals for investment in large-scale off-grid renewable energy but many countries could not borrow because of current debt levels. Despite this situation, policymakers should also recognize the opportunities. Of the US$100 trillion investment needed for greening infrastructure in the next 15 years, roughly 60% will be in emerging markets, particularly in Asia. Several key issues will be crucial when searching for opportunities:

MDBs to maximize finance: Multilateral development banks (MDBs) can play a critical role in achieving sustainability, given the scale of investment needed in emerging markets. But MDBs cannot single-handedly finance the SDGs – they must leverage private sector finance, work to de-risk investments in emerging markets, and ensure the market for sustainable infrastructure bonds. Aggregation of high-performing sustainable infrastructure projects at a scale that attracts the interest of institutional investors and makes them eligible for the secondary bond market (thus allowing some liquidity) could be an alternative. In addition, shifting the role of MDBs to risk mitigation could enable investors to work with emerging country governments and domestic financial institutions to fill the project pipeline, which when operational could then be refinanced by institutional investors.

Transparency: Many low-income poor countries have already gone through the IMF's Heavily Indebted Poor Countries and Multilateral Debt Relief Initiative and came out of the programme with relatively low debt load (about 30% of public debt to GDP). But many of those countries have a high debt (around 70%) to GDP ratio again. As such, private sector lenders, who now lend directly to many sovereign and sub-sovereign borrowers, should demand more transparency on the use of proceeds on behalf of the government.

As stressed by the Blended Finance Task Force, a group of leaders from the private sector, governments, multilateral institutions, and non-governmental organizations, sharing the MDB data track record on sustainable infrastructure projects would help accelerate investments from the private sector, since a key obstacle preventing scale up is a lack of understanding on how these assets perform.

Consistency: Consistent standards across all markets will also be essential. China is a leader on green finance (green bonds, green labels, activities and particularly digital promotion of green activities). But what is 'green' in China may not be 'green' in the EU. Divergence, instead of mutually reinforcing complementarity, could hinder the further development of green finance.

Innovation: Many emerging markets recognize sustainable finance as a source of innovation that drives job creation and new industries. Holding the presidency of the recent UN Climate Change Conference (COP 23), Fiji worked with the World Bank to issue its first sovereign green bond for US$100 million. Malaysia worked with the World Bank to develop guidelines for green sukuk financing (sharia-compliant, non-debt creating financing) and Indonesia recently issued its first green sukuk bond, wherein the investor and the country share risk upside and downside, but without debt obligation. For many emerging markets, disaster risk management is critical, which has led to US$1.3 billion in investments for Chile, Colombia, Mexico and Peru. Beyond insurers and reinsurers, a more diverse set of actors, such as asset managers and pension funds, now invest in this type of instrument.

Thought leadership: Sustainable finance examples continue to grow: the World Bank Terawatt Initiative is creating a market for solar; the One Planet Summit Sovereign Wealth Fund Working Group is finding a common framework to increase climate-related investments; the World Bank is working on an infrastructure loan refinancing initiative; and the Global Concessional Financing Facility (GCFF) is providing subsidies for countries that have provided a public good by hosting Syrian refugees.

MAINSTREAMING SUSTAINABLE FINANCE – INVESTOR PERSPECTIVES/TCFD

As impact investing and integrating ESG strategies move to the forefront for the professional investment industry, mainstreaming sustainable finance is now a tangible shared goal across the public and private financial sectors worldwide. Implementation of the TCFD recommendations will be an important step towards this goal. The TCFD, born under the Financial Stability Board (FSB) at the request of the G20, sought to develop a coherent, scalable framework that would allow for comparable information to be disclosed by companies and financial institutions in order to allow investors, lenders, insurers, and underwriters to make rational capital allocation decisions.

The resulting TCFD recommendations were a game-changer. Positive endorsements came from all corners, including the G20, governments, corporations and assessment managers. They viewed it as a solution for disclosing climate-related material risk information in a comparable, consistent and material way.

Defining sustainable finance – what is 'green' and 'sustainable' – presents many challenges:

* *Difficulties at the margins:* There is broad agreement on the green nature of technologies such as renewable energy. But some technologies, such as coal filter implementation, operate on the margins of sustainability and often provoke divergent opinions.
* *Technological changes:* Today's technology, such as battery storage for electric vehicles, may be sustainable, but future technological innovation might make certain technologies obsolete.
* *Democratizing taxonomies*: The process for defining what is 'green' and 'sustainable' should be open and democratic, and consider a broad set of opinions from different stakeholders.

Corporate levers for TCFD uptake

* *Credit rating agencies*: Transparent reporting is needed on the rankings and methodologies for credit rating agencies that use the TCFD recommendations, including their success in finding the data.
* *Institutional shareholders and shareholder resolutions:* 2018 saw a record level of shareholder resolutions that have pushed companies to perform a two-degree scenario analysis (*i.e.* Exxon, Occidental). There is still a huge gap between what institutional investors want to see and what companies decide to report. Nevertheless, the quality of the engagement is improving, which likely would not have happened without the TCFD recommendations.
* *Regulator involvement*: An increasing number of insurance and pension fund authorities are updating the way they assess insurance sector solvency. They are also being encouraged to develop TCFD-style scenarios as a stress test for the insurance sector.
* *Uptake by corporate governance codes*: Inclusion in corporate governance codes could make the TCFD recommendations a de facto listing rule (comply or explain).

Leaders for TCFD uptake

* *Buy and sell side (companies and analysts)*: In a recent survey, many companies said they would likely use the TCFD guidelines if one of their peers did. A few leaders can pave the way for industry-wide adoption. In time, companies may have to use TCFD due to investor pressure.
* *Buy side:* A growing number of industry analysts are focused on TCFD, although most do not use it in their training courses. Further integration could come from the use of ESG topics in their research, although little of this research focuses on the long term. A Bloomberg survey showed that 75% of analysts have a three-year horizon or less and 95% have a five-year horizon or less.
* *Employees and customers:* It is increasingly difficult to 'hide' from the impact that climate risks could have on a company or the impact the company might be having on the environment. It will become increasingly important for companies that wish to hire and retain employees or to attract customers. Increased public awareness will force companies to address these risks in a manageable, scalable and useful way that works for investors, lenders and insurers.

- *Industry associations & research institutions:* An increasing number of industry associations and research institutions are helping financial institutions work to implement TCFD recommendations by promoting capacity-building. For example, UN Environment's Finance Initiative (UNEP FI) promotes pilot projects to develop scenarios, models and metrics to enable scenario-based, forward-looking assessment and disclosure of climate-related risks and opportunities.

CONTACTS

Bloomberg Philanthropies – Ailun Yang, Environment Program: ailun@bloomberg.org; www.bloomberg.org

EBF – Sébastien de Brouwer, Chief Policy Officer: s.debrouwer@ebf.eu; www.ebf.eu

IIF – Sonja Gibbs, Senior Director, Global Capital Markets: sgibbs@iif.com; www.iif.com

Paulson Institute – Deborah M. Lehr, Vice Chairman: dlehr@paulsoninstitute.org; www.paulsoninstitute.org

SIFMA – Peter Matheson, Managing Director: pmatheson@sifma.org; www.sifma.org

UN Environment – Simon Zadek, Senior Advisor on Sustainable Finance: simon.zadek@un.org; www.unepinquiry.org

The views and opinions expressed in these materials do not necessarily reflect the official policy or position of the sponsors. This Briefing was prepared by the UN Environment Inquiry, with particular thanks to Marcos Mancini, Chad Carpenter, Sébastien de Brouwer, Lisa Fues, Sonja Gibbs, Deborah M. Lehr, Ailun Yang and Simon Zadek. Other publications, including the other briefings in this series, can be downloaded at: http://unepinquiry.org/?s=&post_type=publication.