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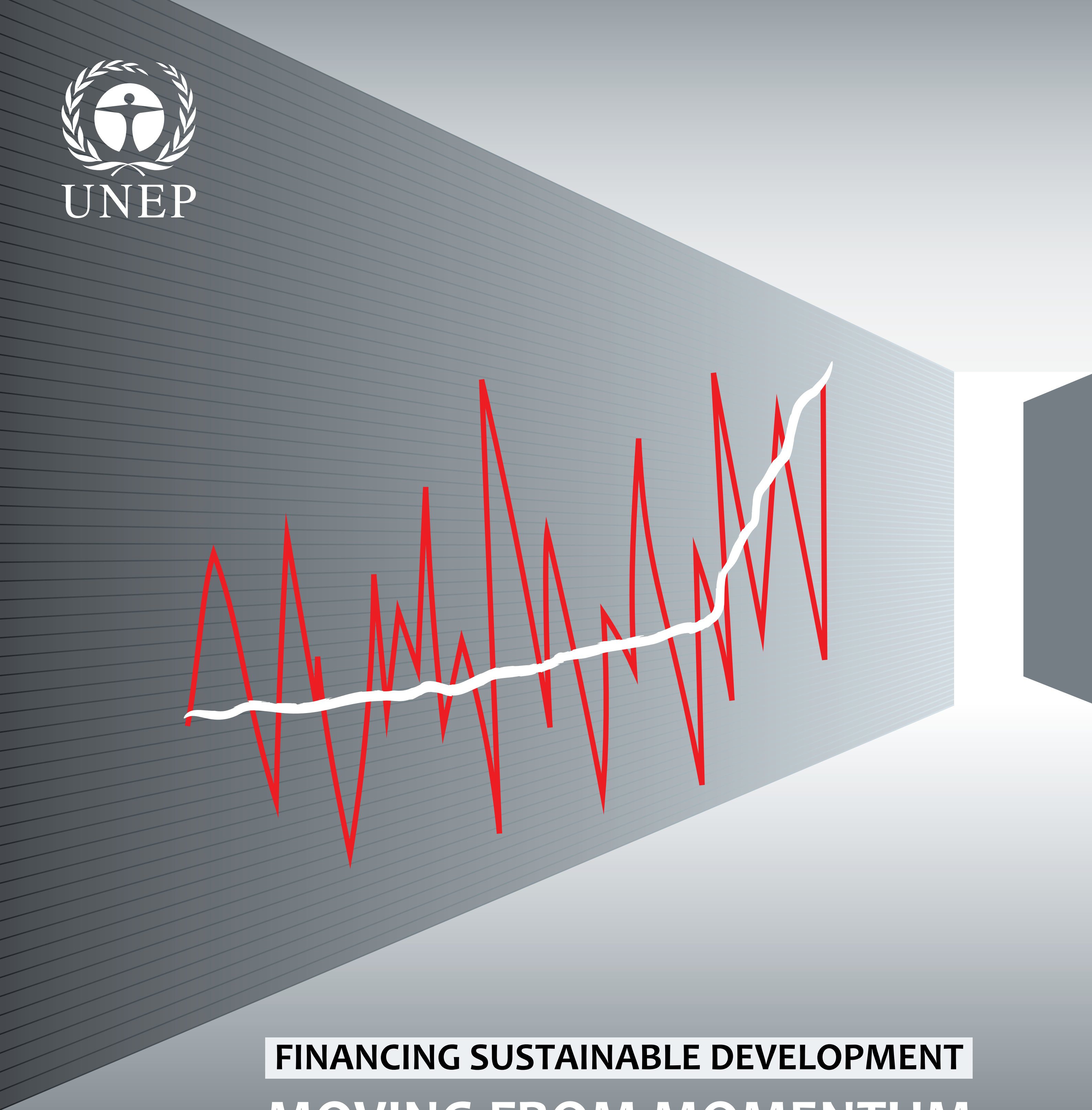

FINANCING SUSTAINABLE DEVELOPMENT

MOVING FROM MOMENTUM TO TRANSFORMATION IN A TIME OF TURMOIL

Inquiry: Design of a Sustainable Financial System

The 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 deliver a step change in the financial system's effectiveness in mobilizing capital towards a green and inclusive economy – in other words, sustainable development. Established in January 2014, it published the first edition of 'The Financial System We Need' in October 2015. The Inquiry's mandate currently extends to the end of 2017, with work focused on deepening and taking forward its findings.

The UNEP Inquiry is pleased to work in association with the UNEP Finance Initiative.

More information on the Inquiry is at: *www.unep.org/inquiry* and *www.unepinquiry.org* or from:

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This report

Simon Zadek and Nick Robins are the Inquiry's co-Directors, and the lead authors of this report. It draws on a meeting on Financing Sustainable Development co-hosted with UN Women in New York on 24 August 2016.

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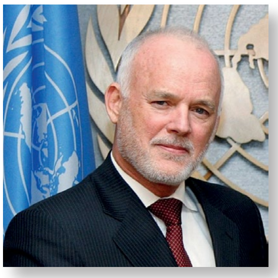
FOREWORD



The seventy-first session of the United Nations General Assembly must accelerate momentum on the 2030 Agenda for Sustainable Development and realizing the urgent ambition of the Paris Agreement. Key to achieving such momentum is the mobilization of the necessary finance. Yet today, we are simply not on track to secure this finance, endangering current and future generations.

It is not enough to just wish there was adequate public finance, or to wonder why the large amounts of private finance seems so hard to persuade to invest in the right things. As the Addis Ababa Action Agenda on Financing for Development highlighted, we have to be practical, but we also have to be ambitious. Most of all, we have to move beyond yesterday's limiting approaches and reset our thoughts and actions.

Unlocking finance for sustainable development is a challenge of our times that we must address head on. *Financing Sustainable Development: Momentum to Transformation* highlights real options to do just that. Far from being distracted by the many immediate problems we face, it shows us how we can work beyond today's turmoil, or even how to build on its momentum. Grounded in the innovations being taken forward by policymakers and market players from around the world, it shows us that it is possible to reshape global finance to meet the needs of sustainable development.

Challenging times need practical and ambitious solutions. The United Nations and its member states have a critical role to play in implementing such solutions, along with traditional partners and a new generation of allies including financial policymakers, central banks and financial institutions. Together, we can ensure that global finance is directed to delivering the financial services and resources needed to deliver sustainable development.

Peter Thomson
President of the 71st session of the UN General Assembly

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FINANCING SUSTAINABLE DEVELOPMENT

MOMENTUM TO TRANSFORMATION

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SUMMARY

The 2030 Agenda for Sustainable Development and the Paris Agreement represent the most ambitious multilateral goals ever set. These goals require an unprecedented mobilization of both public and private finance – some US$90 trillion over the next 15 years. Public finance is scarce and must serve competing priorities. Progress has been made to mobilize private finance by shaping the right enabling investment conditions and crowding-in private capital with public funds.

Momentum is also growing to align at a more fundamental level the financial system with sustainable development. A 'quiet revolution' is building to embed sustainable development into tomorrow's global financial system, revealed in UNEP's 2015 landmark report, "*The Financial System We Need*". Early innovations have been championed by international coalitions of investors, banks and banking regulators, stock exchanges and insurance regulators. Both developing and developed countries have led the way in addressing national development priorities through financial system improvements. Most recently, the G20 finance ministers and central bank governors have, for the first time, explored how to improve the financial system to mainstream environmental considerations, and the Financial Stability Board has established a task force to explore how to ensure that climate-related financial risks are fully accounted for and disclosed.

Despite this positive momentum, progress remains inadequate, with an accelerating decline in all major ecosystems, and growing economic inequality and social challenges. Urgent action is needed to avoid insufficient or misplaced investments that will lock in unsustainable economies and lifestyles. Natural capital has declined in 116 out of 140 countries;[1] 6.5 million premature deaths result every year from air pollution linked to the energy system;[2] greenhouse gas emissions add energy to the Earth's system at a rate equivalent to the detonation of four nuclear bombs every second;[3] an average of 26.4 million people have been displaced from their homes by natural disasters every year since 2008 – equivalent to one person every second;[4] and one third of the world's arable land is jeopardized by land degradation, triggering economic losses of US$6.3 to US$10.6 trillion per year.[5]

Immediate priorities, informed by growing turmoil, too often dominate political and business decisions. Economic volatility and slow growth, alongside political uncertainty, can and do distract policymakers and investors from long-term goals and risk-adjusted financial returns respectively. But turmoil of some kind is a permanent feature of our political and economic landscape. Turmoil creates challenges, but it can also be turned to ambitious advantage. Sustainable development calls for transformative approaches that can thrive in turbulent times.

Current efforts to align the financial system with sustainable development demonstrate how to drive transformation through, or even by leveraging, ongoing turmoil. Post-crisis policy and regulatory changes, strengthened country leadership, and historically low returns to traditional savings and investment – these all create opportunities for advancing sustainable development considerations in financial market reform and development. Profound disruptions to the financial system through technological upheavals ('fintech'), furthermore, create new ways to mobilize

sustainable finance, particularly for developing countries with high savings rates and comparatively underdeveloped capital markets.

Transformative financing can be mobilized by bridging the 2030 Agenda and the Paris Agreement with these financial system innovations. Both require systematic national action, but with a few exceptions, decisions are still made in separate silos. Both would benefit from public-private coalitions that effectively connect ambitious policies with market innovation. Both depend on international co-operation, but together they could combine the strengths of diverse actors historically separated by mandate and approach.

Five steps are proposed to embed financing for sustainable development at the heart of tomorrow's global financial system and deliver the much-needed transformation. These steps build on country-level experience in advancing ambitious plans to ensure that the financial system fulfils its historic purpose of meeting long-term needs, engages key international institutions effectively and develops the new generation of methods and standards that can institutionalize sustainable development in the governance and practice of financial and capital markets worldwide.

ACCELERATORS OF TRANSFORMATIVE FINANCE

1. *National financial market reform and development plans* to embrace consideration of the Sustainable Development Goals and Paris climate commitments, and vice versa.

2. *Financial technology mobilized to support the accelerated alignment of the financial system with sustainable development*, particularly for developing countries.

3. *Public finance to undergo a disciplined analysis and, as required, redeployment* to align to the Sustainable Development Goals and Paris climate commitments.

4. *Investing in awareness-raising and building key capabilities*, so that the financial community can effectively implement new approaches and plans.

5. *Development of common methods, tools and standards* to enable sustainable development priorities to be measured and incorporated into financial practice.

Aligning the financial system with sustainable development is ultimately a policy choice. Ensuring that the financial system serves the needs of sustainable development is a policy choice, which in turn will shape how financial ministries, central banks, financial regulators and standard-setters define and deliver their core mandates. At a global level, these policy choices have already been made, as the 2030 Agenda and Paris Agreement reaffirm the centrality of sustainable development in underpinning viable and inclusive economic strategies and practices. Now these goals and commitments must be embedded across the financial system so that market actors can ensure that capital flows become consistent with sustainable development.

PLACING SUSTAINABLE DEVELOPMENT AT THE HEART OF THE FINANCIAL SYSTEM

The 2030 Agenda for Sustainable Development and the Paris Agreement represent the most ambitious multilateral goals ever set. Achieving these goals requires an unprecedented mobilization of both public and private finance, some US$90 trillion over the next 15 years.[6,7] Public finance is scarce and must serve competing priorities.[8] Momentum is therefore building to mobilize private finance. Early stage developments have focused on shaping the right enabling investment conditions and crowding-in private capital with public funds.[9]

Public finance is essential for realizing the Sustainable Development Goals, and private finance has a role to play when commercial investment opportunities arise. International development funding and domestic public resources are required to fund critically needed developments.[10] Some of these public funds need to be used directly, such as for official development assistance and domestic social welfare payments. In agriculture, for example, the bulk of an estimated annual investment gap of US$260 billion in developing countries will be commercially fundable, but public funds are needed to tackle rural poverty and hunger.[11]

Public funds will always, however, be inadequate to finance sustainable development. Developing countries in particular have severe fiscal constraints, as increasingly do developed countries. Public funds can also be used to crowd-in private capital where commercial opportunities exist, but returns are insufficient to catalyse financial flows, thereby making more extensive use of scarce public resources.[12] Much of private investment in clean tech is, in fact, crowded-in through the use of innovative public financing instruments and renewables feed-in tariffs.[13]

It is increasingly understood that the financial system itself also needs to be reshaped to mobilize sufficient capital for sustainable development.[14] Efforts to build bridges between the finance system and sustainable development have gained considerable momentum. Formal initiatives such as the Addis 'Financing for Development' process have raised awareness and strengthened the resolve to act together.[15] Governments are responding to the 2030 Agenda and the Paris Agreement by developing domestic plans and laying the foundation for enhanced international cooperation. Private financing is increasingly active in many key areas. In 2015, for example, largely private investment in renewables represented almost two-thirds of the net additions to global power capacity in 2015, and the market size of electric vehicles expanded 60% in 2014.[16]

Leading private sector financial institutions also recognize that sustainable development is key to their success. Integrating environmental, social and governance factors can reduce risk and enhance returns as well as expand opportunities for new financial products (such as green bonds). Coalitions have emerged to catalyse and leverage this emerging market leadership, such as institutional investors through the UN-backed Principles for Responsible Investment,[17] insurance companies through the UNEP-hosted Principles for Sustainable Insurance,[18] and the UNCTAD-hosted Sustainable Stock Exchanges initiative.[19] Impact-focused alliances have also blossomed, such as the Portfolio Decarbonization Coalition of Investors,[20] committed to decarbonizing some US$600 billion in asset portfolios.

Exciting developments signal progress in mainstreaming sustainable development into the fabric of financial and capital markets. Private financing is catalysed not only by the pipeline of opportunities but also by the shape of the financial system itself. The UNEP Inquiry into the Design of a Sustainable Financial System highlighted in its 2015 global report, *"The Financial System We Need"*, why and how – in practice – the rules and norms governing the financial system can drive the market responses required to deliver positive sustainable development outcomes.[21] The Inquiry has identified over 200 innovative measures taken by financial policymakers, central banks, financial regulators and standards bodies, to better reflect social and environmental factors – a number that is increasing on a weekly basis.

Private Sector Collaborative Commitments

- ***Banking*:** Banks accounting for 70% of project finance in developing countries have signed the Equator Principles.[22]
- ***UNEP FI***: With 200 banking, insurance and investor members,[23] has helped to create many key initiatives, including the PRI, PSI and the SSE.[24]
- ***Investors:*** Investors with US$60 trillion are committed to the UN-backed Principles for Responsible Investment (PRI).[25]
- ***Insurance*:** 20% of insurance premiums now covered by companies supporting the Principles for Sustainable Insurance (PSI).[26]
- ***Stock Exchanges***: 57 stock exchanges with total market capitalization of US$36 trillion have committed to the Sustainable Stock Exchanges initiative (SSE).[27]

Most of these design changes to the financial system are taking place at the national level, such as:

- *Brazil's* socio-environmental risk regulations for banking introduced by the central bank.[28]
- *China's* new regulations for green bonds, driving US$8 billion of issuance in early 2016.
- *France's* new reporting requirements for institutional investors, a core part of its energy transition strategy.[29]
- *India's* longstanding policy-directed lending being extended to renewable energy.[30]

- *Kenya's* leadership in promoting financial inclusion leading to innovative financing mechanisms that support access to health services and renewable energy.[31]
- *Mauritius'* efforts to align its stock exchange to sustainable development outcomes resulting in the launch of the SEM Sustainability Index.[32]
- *Philippines'* work with the global insurance sector to develop a public-private disaster insurance pool, making and will make disaster insurance compulsory for homeowners and SMEs.[33]
- *The UK's* consideration of climate change as part of the prudential oversight of the insurance sector.[34]

Internationally, co-operation among financial rule-makers is also growing to better align the financial system with sustainable development. There are a growing number of coalitions of financial policymakers and regulators, often including private financial institutions. These include the IFC-hosted Sustainable Banking Network[35] of banking regulators (including the Central Banks of Bangladesh, Jordan, Nigeria and the Philippines) and banks committed to greening lending, as well as the Alliance for Financial Inclusion,[36] with a membership of 90 central banks, such as the Reserve Bank of Fiji and the National Bank of the Republic of Kazakhstan. A new initiative convened by UNEP is seeking to bring together insurance supervisors to examine the sustainability dimensions of their mandates.

More formally, in early 2016, the G20 under China's presidency launched the Green Finance Study Group.[37] Co-chaired by the People's Bank of China and the Bank of England, with UNEP as secretariat, this initiative is mandated to explore options to "enhance the ability of the financial system to mobilize private capital for green investment."[38] Another high-profile initiative is the Financial Stability Board's Climate-Related Financial Disclosure Task Force.[39] Chaired by Michael Bloomberg, and including many of the world's leading financial institutions, this group is seeking to improve the flow and use of information on climate-related risks throughout the financial system through consistent measurement and reporting.

MOMENTUM REMAINS INSUFFICIENT

This positive momentum does not mean that enough is being done on the relevant timescales. While moving in the right direction, current efforts to finance sustainable development are a long way from what is needed. In considering the environmental dimensions of the Sustainable Development Goals, for example, natural capital has declined in 116 out of 140 countries;[40] 6.5 million premature deaths result every year from air pollution linked to the energy system;[41] greenhouse gas emissions add energy to the Earth's system at a rate equivalent to the detonation of four nuclear bombs every second;[42] an average of 26.4 million people have been displaced from their homes by natural disasters every year since 2008 – equivalent to one person every second;[43] and one-third of the world's arable land is jeopardized by land degradation, triggering economic losses of US$6.3 to US$10.6 trillion per year.[44]

Financing for sustainable development is likewise inadequate. UNCTAD estimates that there are major financing shortfalls across most efforts to address Sustainable Development Goals, as much as US$2.5 trillion annually for developing countries.[45] Only 5-10% of bank loans are 'green' as reported in the very few countries where national measures of green loans are available. Despite the rapid expansion in the green bond market, less than 1% of total bond issuance is made up of labeled green bonds. Only 60 jurisdictions have taken any action so far to introduce measures to align their financial systems with aspects of sustainable development – and none have in place a fully comprehensive approach.[46]

Barriers to Transformational Financing

Multiple barriers exist to mobilizing transformative levels of financing. These include weaknesses in project pipelines, significant incremental costs to 'greening' infrastructure, poor commercial opportunities in financing the realization of some goals, scarcity or poor use of available public resources, and inadequate enabling environment for private investment.

The G20's innovative work on green finance highlights barriers within the financial system itself.[47] Core is the continued failure in financial decision-making to count environmental and related financial impacts. Information asymmetries explain this shortfall in part, as financial decision-makers do not have the data to understand social and environmental factors. Short-termism can deter financing from sustainable investments that tend to be more capital intensive with associated lower operating costs.[48] Mispricing environmental risk can deter green financing and encourage investment in pollution intensive assets.

As a result, we risk continuing to slip backwards as the bulk of financing flows towards unsustainable production and consumption patterns. *Without more rapid, scaled redeployment of financing, we will lock in development trajectories that deny the realization of the global goals and take us beyond the tipping points for life-supporting climate and wider ecosystems.*

SUSTAINABLE FINANCING AT A TIME OF TURMOIL

Today's economic uncertainty and volatility are often cited as the key reasons that finance is not flowing to the long-term investments needed for sustainable development. Since the global financial crisis, key aspects of the financial system have been in a state of rapid change. Many of these changes are positive – such as the introduction of post-crisis regulation to restore integrity and stability to core financial markets.[49] Others are problematic – such as the apparent break in the long-term trend to increasing cross-border capital flows.[50] Weak underlying growth in many leading economies continues to deliver historically low interest rates, challenging some of the traditional fundamentals of financial practice. And financial technology (fintech) is starting to challenge business models in key financial sectors – and looks set to unleash more structural disruptions in the years ahead.[51]

The challenge is how to achieve the transition required for sustainable development at a time of turmoil. It is unlikely that we will move into a period of relative calm allowing for longer-term considerations to be more fully addressed. Rather this period of recalibration of core features of the financial system offers an opportunity for advancing the sustainable development agenda.

Large pools of financial capital managed by pension funds and insurance companies, for example, are today facing historically low-interest rates, and could provide the basis for financing capital-intensive long-term investment. Yet investment levels remain well below what is needed, while corporate cash-hoarding remains at an all time high of more than US$5 trillion.[52] An internationally coordinated investment programme could deliver a low-cost boost to short-term growth and advance much needed, low carbon, resilient and productive infrastructure. Such investments could, if delivered through crowded-in private finance, help institutional investors overcome severe revenue and asset valuation shortfalls against future liabilities, and so help in protecting future income streams for ageing populations.

Today's disruptive changes to the financial system could provide other avenues for mobilizing finance for sustainable development at transformational scale. UNEP's ongoing research on the nexus of fintech and sustainable development has highlighted the potential to drive green as well as inclusive finance in developing countries.[53,54] Greening SME-financing can become a reality as fintech enables low-cost investor due diligence and ongoing performance monitoring.[55] Fintech could empower investors through improved information flows, similarly, to make values-aligned, improved choices, and likewise connect domestic savers to opportunities that could also boost the local economy and public services.[56]

In the wake of the financial crisis, furthermore, central banks and financial regulators are giving greater consideration to broader policy objectives.[57] As well as classical economic objectives, such as the US Federal Reserves employment-related mandate, this increasingly includes related social and environmental goals. Peru's Superintendency of Banking, Insurance and Private Pension Fund Administrators (Superintendencia de Banca y Seguros) has placed increasing emphasis on ensuring investor oversight over mining-related social and environmental risks, given their potential macroeconomic effects.[58] Following the financial crisis, the mandate of the Dutch central bank, DNB, was updated to "safeguard financial stability and thus contribute to sustainable prosperity in the Netherlands". DNB is acting as a catalyst for discussions on sustainability in the financial sector and has established a new Platform on Sustainable Finance in 2016.[59]

TRANSFORMATIONAL FINANCE FOR SUSTAINABLE DEVELOPMENT

The transformation needed requires strategies that amplify the current momentum, whilst leveraging the upside opportunities associated with turmoil. Such a gear-shift requires that we move sustainable finance from 'cottage industry to industrial scale'.[60]

Making the most of public finance can take us a long way, including better use of current public funding arrangements.

Existing flows of public finance could be more effectively aligned to sustainable development outcomes.[61,62]

- *Tax relief* is often given on mortgages, in effect public subsidies, which could be used to incentivize energy efficiency investments. Similarly, tax relief is around the world offered on commercial and sovereign debt, but could be used to create added value in certain types of investment aligned to sustainable development outcomes, such as green bonds.[63]
- *Public financing vehicles*, such as pension funds, national security funds, and sovereign wealth funds, could introduce relevant environmental, social and governance criteria to align investments with sustainable development.[64]
- *Public procurement*, often a third or more of the aggregated demand of any national economy, could go further in giving preference to sustainability-aligned financial services, including indirectly by, for example, only purchasing financial services from companies with strong sustainable finance performance.[65]

The rules that govern private capital can also be better focused on sustainable development outcomes. Financial market reform and development has for the first time in modern history begun to take account of sustainable development imperatives. As previous examples illustrate, the 'quiet revolution' identified by the Inquiry involves a growing number of institutions responsible for financial system governance recognizing that 'sustainable development is my business'.[66]

National action in aligning financial system development with sustainable development can become the 'new normal'. Nearly all countries now have financial sector reform and development plans. The challenge is to connect these with sustainable development. A number of leadership cases show how this can be done using diverse approaches that flow from national priorities and so provide the foundation for a more systematic and ambitious approach.

- *China's* 'Green Finance Task Force', co-chaired by the People's Bank of China and UNEP, delivered a set of 14 recommendations covering fiscal, policy, regulatory, judicial and institutional measures, most of which are now incorporated into China's 13th Five-Year Plan.[67]

- *Indonesia's* financial regulator (Otoritas Jasa Keuangan) introduced a Sustainable Finance Roadmap to strengthen the competitiveness of its financial sector and align it to long-term sustainable development priorities.[68]
- *In the UK*, the City of London has established a 'Green Finance Initiative' aiming to develop London as a global hub for green finance,[69] an approach that is also being pursued by other financial centres, including Hong Kong,[70] France[71] and Switzerland.[72]

Innovations in these and other financial centres in many ways shape the basis on which private capital is available in developing countries. To take the example of green bonds. Total green bond issuance has now exceeded US$150 billion for the first time – and is so far led by a number of key industrialized and emerging markets, such as China, France, the UK and the US. The development of shared market-based principles and standards, increasingly supported by national regulations, is helping to drive down the transaction costs for green bonds and increase liquidity, making it easier for developing countries to tailor this momentum to their own needs. In addition, it is critically important that the specific needs and concerns of developing countries are now incorporated into these market developments.[73]

National leadership informs how sustainable development can also be built into the financial system architecture and practices at the international level. Already we see a growing number of central banks exploring the critical nexus between climate-related risks and financial stability, including the Bank of England and the European Systemic Risk Board.[74,75] In addition, national strategies are often co-developed with, guided, or monitored, by key international organizations, such as the IMF and the World Bank Group.[76] As more and more action takes place at the national level, so the potential to share experience and develop common approaches grows.

Financial inclusion offers a model for how a sustainable development priority can become mainstream.[77] In recent years, financial inclusion has moved from an ad hoc set of country experiences to become a more systematic aspect of financial system development. Today, financial inclusion is now built into a growing number of international financial methodologies and standards, such as the Financial Sector Assessment Program (FSAP) overseen by the IMF and the World Bank Group.[78] Similar developments could draw in other aspects of sustainable development particularly relevant to financial system stability and development. Many of the key global financial standards have critical synergies with sustainable development – the task now is to realize these in practice.[79]

FROM MOMENTUM TO TRANSFORMATION

Today's momentum can be amplified to unlock transformational levels of financing for sustainable development. This is true for both public and private finance, and importantly the nexus between the two. Five steps are proposed to embed financing for sustainable development at the heart of tomorrow's global financial system. These steps build on country experience in advancing ambitious plans to ensure that the financial system serves its historic purpose, effectively engages key international institutions, and develops a new generation of methods and standards that institutionalizes sustainable development in the governance and practice of financial and capital markets worldwide.

Accelerators of Transformative Finance

1. *National financial market reform and development plans*, including ongoing post-financial crisis measures, to incorporate sustainable development and climate change priorities, linked to 2030 Agenda-related and climate action plans, and enabled by coalitions of public and private actors tasked to co-design and guide implementation.

2. *Financial technology mobilized* to support the accelerated alignment of the financial system with sustainable development, particularly enabling developing countries to leapfrog in mobilizing and deploying domestic savings and international funds to financing sustainable development.

3. *Public finance to undergo a disciplined analysis and where appropriate redeployment* of its direct and indirect contribution to realizing the 2030 Agenda and Paris Agreement commitments, including public procurement, instruments for crowding in private finance, and fiscal incentives provided through the financial system.

4. *Investing in awareness-raising and building key capabilities*, so that the financial community can effectively implement plans including taking advantage of new opportunities, to ensure that policymakers and regulators are fully engaged in the imperatives and risks associated with such plans, and that public debate is better informed, and activated as an enabler of change.

5. *Development of common methods, tools and standards* to enable sustainable development priorities to be incorporated into financial practice and performance to be measured, enabled by the active engagement of key international organizations with financing mandates.[80]

Aligning the financial system with sustainable development is ultimately a policy choice. Ensuring that the financial system serves the needs of sustainable development is a policy choice, which in turn will shape how financial ministries, central banks, financial regulators and standard-setters define and deliver their core mandates. At a global level, these policy choices have already been made, as the 2030 Agenda and Paris Agreement reaffirm the centrality of sustainable development in underpinning viable and inclusive economic strategies and practices. Now these goals and commitments must be embedded across the financial system so that market actors can ensure that capital flows become consistent with sustainable development.

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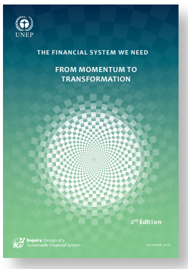
* Publications



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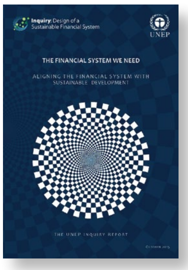

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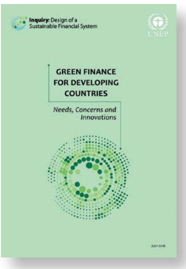

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