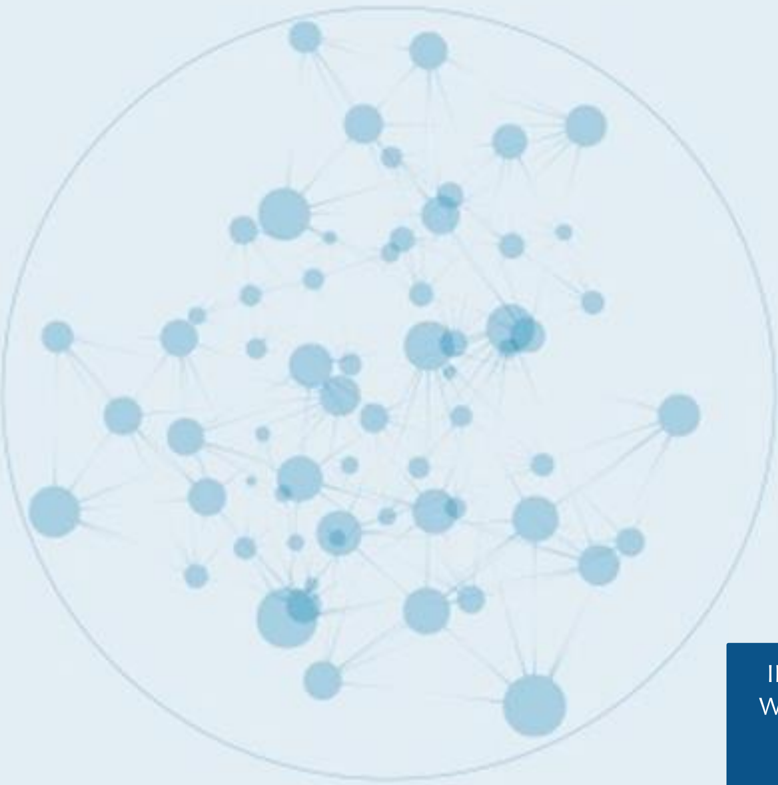
Inquiry: Design of a Sustainable Financial System

UNEP

DESIGNING FOR DISRUPTION

The UNEP Inquiry Scenarios



INQUIRY WORKING PAPER

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The UNEP 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 improve 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 its global report, The Financial System We Need, in October 2015 and is currently focused on actions to take forward its findings.

More information on the Inquiry is at: *www.unep.org/inquiry* and *www.unepinquiry.org* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

About this report

This initial scenario framework was developed through a process of research and interviews, as well as through workshop sessions with the Inquiry's Advisory Group, key country partners and with technical experts from the OECD, led by Angela Wilkinson (OECD) with key contributions from Betty-Sue Flowers, Pam Hurley and Martin Mayer.

Comments are welcome and should be sent to *simon.zadek@unep.org*.

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1 Why Scenarios?

Tomorrow's financial system will not look like today's. Possibilities will be shaped by new entrants and technologies and by shifts in the global economy's centre of gravity. Crises and innovation may present unpredictable and alternative pathways of change.

The Inquiry, with support from the OECD, therefore developed a set of scenarios to frame discussions of the possible future policy contexts within which a sustainable financial system needs to evolve.

Scenarios are…

✗	✓
Predictions	Consequential
Projections	Challenging
Preferences	Plausible

The future is an orientation – a conceptual sense – that actively shapes our perception of reality whether this is made explicit or not. Scenarios are stories of the future and how it came about; they are not predictions, forecasts or policy options. Instead, they offer different frames or lenses for generating strategic conversations about possible developments and turning points. They support decision makers in engaging with future developments that are already taking place and beyond their direct control. Scenario planning enables a productive dialogue to generate shared insights and forges new common ground – which offers a better basis for more effective collaborative action.[1]

The scenarios were used to shape and frame the early discussions of the Inquiry Advisory Group, as well as other strategic conversations with private sector actors, financial regulators and policy makers and the research community.

If we focus only on the present day, discussions about the financial system and about sustainability tend to involve separate groups of experts each with their own language and sphere of knowledge. Framing the discussion by looking to the future helped to break down these barriers – no one can claim to be an expert about the future.

[1] For more details of the scenarios approach, see Ramírez, R. and Wilkinson, A. (2016). Strategic Reframing: The Oxford Scenario Planning Approach. *https://global.oup.com/academic/product/strategic-reframing-9780198745693?q=ramirez&lang=en&cc=g*

2 Inputs

Perspectives from Leaders and Practitioners

The scenarios framework was shaped by interviews with a diverse range of thought leaders and practitioners from public and private sectors and civil society, who reflected on the current and future role of the financial system.

They recognized and articulated the problem that finance is not allocating capital towards solving the problems of sustainable development, and highlighted the ongoing change and disruption in the financial sector itself from new technology-enabled business models.

Interviewee perspectives

*"Finance is a lubricant for the **real sector**, which is the engine of change. It follows, it does not lead."*

*"People say bankers have become more greedy. I don't think so. Bankers have always been interested in money. But it is **corporate governance** that has changed."*

*"The brokerage function has gone feral. The **financial sector is absorbing too much of society**."*

*"We need more new **offerings of new financial products** in favour of sustainable development."*

*"Finance is aligned to **short-term performance**."*

*"**Regulators** do not have the necessary resources and not enough political will to control the financial sector."*

*"**Technology**-enabled low-cost trading platforms will increasingly undercut ability to set standards."*

*"Global constraints like carbon or water must become appropriately recognized in **real prices**. The problem cannot be solved in the financial system."*

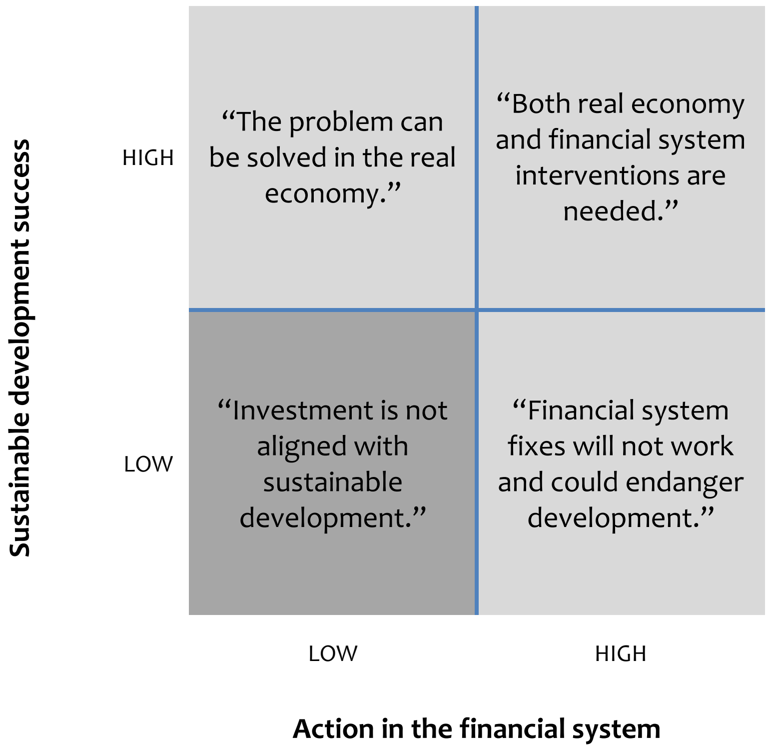
*"Regulating the banks is not going to be a game changer. It is like squeezing the balloon – the **problem moves elsewhere**."*

Revealing and Respecting Different Perspectives to Open Up the Solution Space

Interviewees agreed that current patterns of investment are not delivering the needed transition to sustainability.

But they had different views as to whether changes to the financial rules of the game are needed or whether this could endanger development by undermining the efficiency and resilience of the financial system.

Mental models about the solution space



While most interviewees agreed we are currently in the bottom left hand quadrant with low action in the financial system and low progress towards sustainable development. Some felt that financial system action is not needed as problems can be solved in the real economy. Others went further arguing that high levels of action in the financial system would endanger development. However some, in the top right quadrant argued that both financial system, and real economy interventions are needed to drive the transition to sustainability.

Engaging with Uncertainties

In thinking about what is shaping the from and function of tomorrow's financial system, interviewees highlighted geopolitical and global economic shifts, technology and associated business model changes, and environmental systemic risks as key areas of uncertainty.

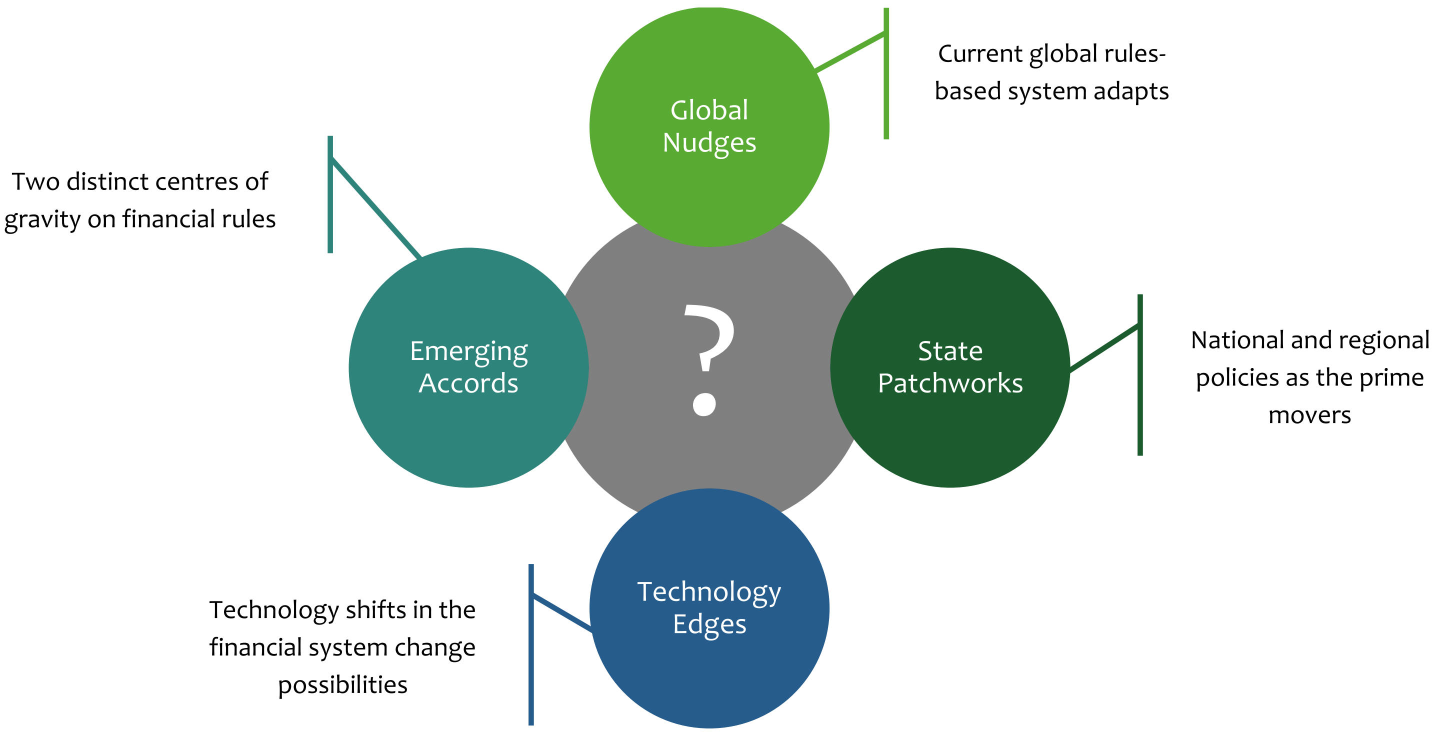
Source of innovation	Will incumbents adapt, or will disruption come from new entrants?
Coherence or diversity	Will there be a single dominant global system or will it diverge into a bipolar or fragmented world?
Impact of technology	Will financial technology-driven changes be significant for sustainability?
Nature of systemic risk	Will social and environmental challenges become systemic financial risks?

3 The Scenarios Framework

Four Scenarios of the Future

A scenarios framework of four future stories was developed. Each one reflects a potential future in which the financial system is aligned with sustainable development, albeit in different ways.

Global Nudges	Governments and international bodies work together broadly within the current rules-based system.
Emerging Accords	Financial systems cluster around several centres of gravity reflecting current consensus and emerging economies.
State Patchworks	Sustainability is advanced through sub-national, national and regional efforts rather than top-down solution.
Technology Edges	New technologies and business models disrupt the existing system and shape a new financial architecture.



Looking back from 2030

Global Nudges

The prudential requirements and supervisory framework put in place after the financial crisis of 2008 became established as an international financial framework for a safer, simpler and globally connected financial system. More countries and central banks joined the international framework and levels of integration of capital markets and banks reached new highs.

Although there were wobbles in 2018 and 2020, the system has shown that globally systemic banks can now be resolved without recourse to the taxpayer and without jeopardizing financial stability. Confidence is restored in globally tradable securitized assets, including green bonds, which are now a standardized part of the economic landscape. Many pension funds, foundations and private investors have adopted investment standards which require specified levels of 'dark' or 'light' green certification of their assets.

Greater reliance on market-based finance has led to increasing focus on ensuring resilience, and environmental stress tests are now routinely included in capital adequacy stress tests. The financial system is increasingly integrated and concentrated, with a few global financial institutions dominating and essentially acting as universal investors. Increasingly, they recognize systemic environmental risks to their portfolios and assets, and have been successfully calling for transparency in reporting on carbon, water and other environmentally related risks, and for governments to establish adequate pricing and regulations.

Emerging Accords

In the decade of the 2020s, systems of multilateralism waned and countries began to separate into two poles, clustered around the major emerging economies motivated by the idea of the 'developmental state' and a Transatlantic Treaties pole focused on North America and Europe, cleaving to the ideals of market liberalism.

Environmental standards, particularly in relation to local water and air pollution, as well as financial and social inclusion, are particular concerns for the rapidly growing economies. The New Development Bank and the Asian Infrastructure Bank have quickly grown to become new financial centres with loan books that compare to, and have started to dwarf those of the World Bank and incumbent regional development banks. They have developed their own governance and environmental standards with greater focus on issues such as financial inclusion and empowerment, and greater flexibility to align procurement and credit allocation with industrial development goals and job creation.

The course of development within and between new regional blocs is bumpier and highly uneven, with states lacking geopolitical or natural resource advantages struggling to attract international capital and technology. Although they retain the shorthand of 'East' and 'West', alliances are mixed and not all countries remain in their initial polarities. The two clusters remain connected through pragmatic arrangements based on shared interests in trade and investment and the need to solve problems that cross borders. By the end of the decade, a new accord begins to emerge based initially on increasingly converging environmental standards and imperatives.

State Patchworks

For much of the 20th century, global finance was more patchwork than network, and this situation has returned, as the multilateral system established in the last century fades and countries, regional groupings and cities develop their own highly differentiated financial systems.

Despite the efforts of the FSB and the G20 in the years following the financial crisis, the fixes proved unstable, and the ties of financial integration gradually came undone, leading to a fragmentation of rules for financial services. Bank lending across borders is minimal and attracts a significant premium. Stock markets and financial regulators, banks, pension funds and insurers are much more domestically focused.

Governments are increasingly aligning financial regulations towards industrial and economic objectives focused both on stability and efficiency, but also in some cases on social and environmental concerns. Banks, pension funds and insurers in many countries are required to provide low-cost services in rural areas and for SMEs, and to invest in strategic sectors including renewable energy and energy efficiency. National development banks, as well as national pension funds and state-owned banks, are increasingly important players, investing directly in infrastructure, green and social impact bonds. Some countries have achieved significant success through this approach leading to accelerated pockets of technology development in many places, while others have succumbed to lack of market discipline.

Technology Edges

The financial system has been transformed by faster, cheaper processing power, and the integration of 'smart everything' which allows much closer real time monitoring of economic value and activity. Businesses use this information to assess and price every kind of risk in real time, undercutting the margins that supported the old financial sector, and commoditizing many areas such as investment banking, asset management and insurance.

Regulators' private standards such as stock market listing requirements and accountancy standards struggle to catch up. Annual accounting and risk ratings have become an anachronism, as global trading platforms use data from transactions to assess the financial health and credit-worthiness of businesses on a minute by minute basis. Centralized stock markets, unable to monetize their market regulation standards, have given way to fragmented alternative trading systems that seek to distinguish themselves through their own pay-to-play rulebooks.

In many of what were the 'emerging markets', old-style banking and stock markets never really got off the ground at all, with financial systems that leapfrogged straight to the mobile money, cryptocurrencies and alternative trading systems.

These new market players are increasingly setting the rules of the game, through the algorithms embedded in new financial products. Public policies are increasingly outcome-focused, and use financial instruments as a mechanism. For example, public health budgets now include a significant portion that is spent on risk reduction bonds in areas such as stress and pollution.

4 Using Scenarios

Scenarios are neither a strategy nor a solution but offer a means to stress test, invent or redesign policy options. The value of scenarios is not that any one of them will come true, but that they to provide a platform for reflection and discussion of future developments that may be taken for granted or overlooked in existing solutions. As a set, the scenarios make explicit the dynamics that are shaping possible pathways today. They enable decision makers to take a step back from the urgency of the pressure to fix the post-crisis financial system and consider what is important to the design and function of an effective system in the future.

Four scenarios – implications for changing the rules

	Global Nudges	Emerging Accords	State Patchworks	Technology Edges
Who sets the rules?	Single set of international financial institutions.	Two broad coalitions of governments and associated standard setters	Fragmented national, regional and city governments, central banks and standard setters	Private and mutually governed market and technical standard setters.
What drives sustainability into financial rules?	Concerns for efficiency and resilience of financial markets	Mix of industrial policy and efficiency concerns	Synergy with industrial policy, energy and resource security, and health	New abilities to price sustainability-related risks
What mechanisms and policies predominate?	Risk-based approaches: risk ratings, disclosure, stress tests	Mix of public directed lending and risk-based approaches	Public banks and state-directed lending	Markets for internalizing long-term risks, new private standards

The scenarios can also branch into each other: frustration with the slow pace of change and one-size-fits-all approach of *global nudges* could lead to fragmentation into *state patchworks;* the inefficiency and tensions of a disintegrated financial system could lead to clustering into *emerging accords.* The technology-enabled disruptions imagined in *technology edges* are likely to emerge within any scenario, although perhaps at different speeds. Elements of each of the four scenarios can already be seen in current developments. Perhaps the most plausible future is a composite one, where each scenario is partially realized at different times, and in relation to different parts of the financial system.

For any set of scenarios to be useful they must be used. The “aha” moment is generated when a view from the future allows us to reconsider options and threats for the present situation. The UNEP Inquiry used the scenarios to support discussions by the Advisory Council and with practitioners and researchers, which fed into the Inquiry global report The Financial System We Need.[2]

[2] Downloadable from *www.unepinquiry.org*

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