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# Mobilising the Financial System for Sustainable Development

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## Overview

2015 could be the year when the long-separated agendas of financial reform and sustainable development are brought together. Now that measures to address some of the critical flaws that led to the financial crisis have been put in place, attention is turning to the rules and incentives needed to mobilise investment for a lasting recovery, one that also confronts rising inequality and continuing degradation of the environmental resource base.

We know that *'current financing and investment patterns will not deliver sustainable development'*.[1] For developing countries alone, UNCTAD has estimated a US$2.5 trillion investment gap for the Sustainable Development Goals (SDGs) each year through to 2030.[2] But the world is not short of capital—with over US$300 trillion in assets held in the financial system. What is missing is a policy architecture that matches the demand for capital with supply and delivers this in ways that support long-term sustainable development.

To bridge this gulf, policymakers have two main levers. The first is the long-standing agenda around the deployment of public funds, domestically and internationally, through government spending, tax incentives and development banking. The second is the new and rapidly emerging agenda of influencing the 'rules of the game' that govern the allocation of capital in the wider financial system. If the first lever is about the government's role as supplier of finance, the second focuses on its role in steering private capital through policies, regulations and partnerships so that the sustainability imperative is effectively incorporated into financing decisions.

This is the area that the Inquiry into the Design of a Sustainable Financial System is seeking to illuminate. Established by UNEP in January 2014, the Inquiry is tasked with advancing policy options that would generate a step change in the financial system's effectiveness in mobilising capital for sustainable development. The Inquiry is guided by an international advisory council and its work involves partnerships with governments, the private sector and civil society across a range of countries and regions including Bangladesh, Brazil, China, Colombia, the European Union, India, Indonesia, Kenya, South Africa, Switzerland and the USA. It will release its final report at the end of 2015.

In its first year, the Inquiry has identified a growing number of innovations in financial policy, regulation and standards that could have transformational potential. In its latest progress report, the Inquiry highlighted three of the key asset pools that need to be mobilized: banking, bond markets and institutional investors.[3]

- **Banking**. Banks hold the largest pool of global financial assets (US$139 trillion), and developing country leadership in 'green credit' regulations points to a new phase in international banking standards. In 2012, for example, China's Banking Regulatory Commission introduced its 'green credit guidelines' with the goal of encouraging banks to "increase the support to a green, low-carbon and recycling economy, fend off environmental and social risks, and improve their own environmental and social performance." Last year, the Central Bank of Brazil (BACEN) introduced a new resolution requiring the banks it regulates to implement environmental and social risk systems. For BACEN's Aloisio Tupinamba "sustainability is a positive asset for financial and monetary stability." And in

[1] ICESDF (2014). Report of the Report of the Intergovernmental Committee of Experts on Sustainable Development Financing. New York: UN.
[2] UNCTAD (2014). World Investment Report 2014 - Investing in SDGs. Geneva: UNCTAD
[3] UNEP Inquiry (2015). Pathways to Scale – The Inquiry's 3rd Progress Report. Geneva: UNEP.
http://www.unep.org/newscentre/Default.aspx?DocumentID=2817&ArticleID=11124&l=en

Bangladesh, the central bank announced in September 2014 that as of 2016 every financial institution will be obliged to allocate at least 5% of its loan portfolio to green finance.

- **Bond markets**. With US$100 trillion in assets, bond markets have a dual significance for sustainable development. The first is the way that sustainability risks are factored into the creditworthiness of project, corporate and government bonds. According to the ratings agency S&P, climate change is one of the two megatrends (along with demographics) that will shape economic risk for government bonds in the 21st century.[4] The second is a direct source of capital through 'green bonds,' which ring-fence funds for green economy investments in areas such as agriculture, buildings, energy, industry, transport, water and waste. An estimated US$500 billion or more of bonds are already linked to green economy and climate investment themes, with issuance of new 'green bonds' of US$36 billion in 2014, more than three times the size in 2013. One of the highlights of 2014 was the launch of the first developing country 'green city bond' from Johannesburg.[5] Policy measures that could help the 'green bond' market to grow to US$1 trillion by 2020 include a focus on local currency debt markets in developing countries, strategic issuance by cities, development banks and other public agencies, as well as incentives such as guarantees, credit enhancement and tax breaks.

- **Institutional investment**. Across the world, institutional investors managed assets of US$93 trillion in 2013 in mutual funds, pensions, insurance companies, sovereign wealth funds and foundations. These investors allocate capital across all asset classes, notably bonds, listed equities, property, private equity, and infrastructure, as well as hedge funds and derivatives. As a group, institutional investors have done more than most to integrate sustainability into their operations, extending a traditional focus on governance to incorporate environmental and social factors. For example, US$45 trillion in assets now support the UN-backed Principles for Responsible Investment.

  Looking ahead, three policy priorities are emerging: first, identifying new mechanisms for matching institutional capital with an attractive pipeline of sustainable infrastructure investments; second, making sure that the incentives that drive behaviour along the investment chain, such as remuneration, reward long-term activity; and third, integrating sustainability into the key rules that govern investors such as fiduciary duty, solvency and risk. Here, South Africa has been one of the pioneers through the reform of its pensions legislation to make clear that the integration of material environmental, social and governance factors was part of prudent investing, backed by the voluntary Code for Responsible Investment in South Africa (CRISA).

Cutting across all these and other asset pools is the need to overcome the prevailing short-termism of financial markets. For the Governor of the Bank of England, Mark Carney, this is a 'tragedy of horizon,' whereby new challenges to long-term prosperity and economic resilience, such as climate change, manifest themselves beyond the standard regulatory and market outlook of at most 2-3 years. Speaking at the 2014 World Bank/IMF Annual Meeting, Carney highlighted that the vast majority of fossil fuel reserves could become 'unburnable' in the transition to a low-carbon economy, resulting in 'stranded assets.' The Bank of England is now undertaking a review of how climate factors could impact the insurance sector, and has also asked its Financial Policy Committee to consider climate risks as part of its regular horizon scanning on financial stability risks.

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[4] https://www.spratings.com/economic-research/Climate-Change.html
[5] http://www.climatebonds.net/2014/06/just-out-first-emerging-market-green-city-bond-city-johannesburg-green-bond-approx-r15bn#sthash.N5nXqn6R.dpuf

Building on these innovations at the country level, 2015 has the potential to be a powerful catalyst for sustainable financial systems, with a series of major international milestones through the Financing for Development conference (Addis Ababa, July), the finalization of the new Sustainable Development Goals (New York, September) and the completion of a new global agreement on climate change (Paris, December). The prize is a framework of incentives and rules that can shift the trillions in the financial system towards a pattern of value creation that supports sustainable development over the long-term.

For more information: *www.**unep**.org/**inquiry**/*