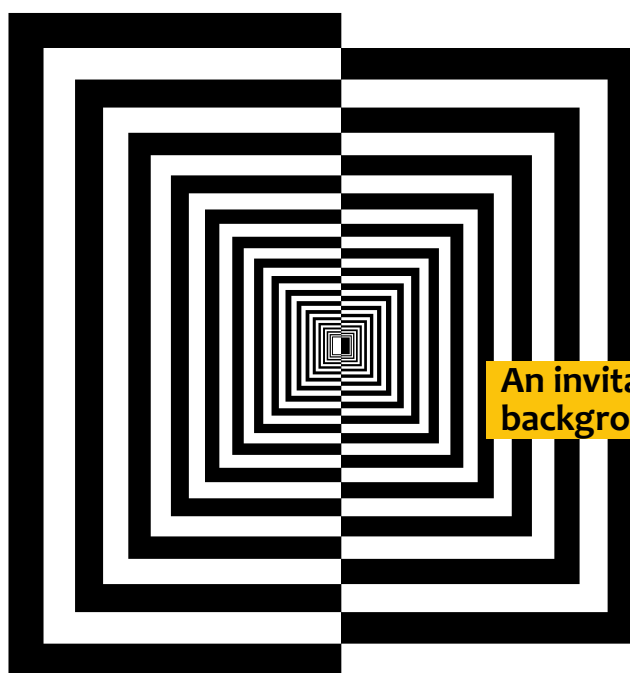




# ALIGNING

THE FINANCIAL  
SYSTEM WITH  
SUSTAINABLE  
DEVELOPMENT



An invitation &  
background briefing

This paper has been produced by the Inquiry's Secretariat as an invitation to engage in its activities.

It also provides a background briefing on the case for linking the development of the financial system with green and inclusive policy objectives, highlights emerging innovation across the world, and offers a set of questions and themes to frame inputs and feedback to the Inquiry's work.

This paper is based on an initial mapping of existing efforts to align the rules that govern the financial system with a green and inclusive economy, as well as inputs from the Inquiry's Advisory Council and dialogue with policymakers, financial institutions and civil society organisations.

Comments or questions about the paper, or general enquiries, can be addressed to:

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## Acknowledgements

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Errors and omissions in this paper are the responsibility of the Inquiry.

Pages 2 and 44 (which are blank for print pagination) have been omitted from this pdf.

## The Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance design options that would deliver a step change in the financial system's effectiveness in mobilizing capital towards a green and inclusive economy.

Established in January 2014, it will publish its final report in the second half of 2015.

More information on the Inquiry is at: <http://www.unep.org/greeneconomy/financialinquiry> or from:

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## UNITED NATIONS ENVIRONMENT PROGRAMME

Programme des Nations Unies pour l'environnement Programa de las Naciones Unidas para el Medio Ambiente

Программа Организации Объединенных Наций по окружающей среде

برنامج الأمم المتحدة للبيئة

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Getting the economics right is key to our collective effective stewardship of the environment. At UNEP, we have for many years engaged on these economics with governments and also business and wider civil society. Our ground-breaking report *Towards a Green Economy*, released in 2011, made the case for accelerating the transition to a green, inclusive economy, since when we have worked with many governments to translate potential into practice.

Financing remains one of the greatest challenges in advancing sustainable development. UNEP has long recognized the need to attract private capital to this challenge as well as mobilizing public finance. The UNEP Finance Initiative was established in 1992 as a means of engaging banks, institutional investors and insurance companies, and since then has contributed to progressing the incorporation of environmental, social and governance issues into their considerations.

Today, there has been much progress, but not enough to prevent growing local and global environmental stresses. Finance for the green economy remains inadequate, and the natural resource and carbon intensity of most private capital markets is still increasing. It is clear that individual investors, however large, can only do so much in bucking this trend. Crucially, the recent economic crisis has highlighted the importance of the overall functioning of the financial system in shaping what it does, and does not, invest in.

UNEP has therefore taken a next step in supporting the transition to a green economy. In January 2014, we established an Inquiry to explore and develop policy options for better aligning the financial system to the needs of sustainable development, focusing on financial and monetary policies, regulations, standards and norms and fiscal measures. This Inquiry will carry out its work over the next 18 months, submitting its reports in the second half of 2015.

The Inquiry's approach is to focus on existing policy innovations, engaging widely at the country and international levels, as well as commissioning policy analysis and technical research. Over its life, it will widely solicit opinion and proposals, as well as making full use of a high-level Advisory Council established to guide its work. In this spirit, this initial publication is intended as an invitation to those with experience, knowledge, and interests, to come forward and engage with the Inquiry's able Secretariat and open process in offering learning, insights and proposals.

It is a moment in time where ambition and focus is needed to advance the green economy to the next level of scale and relevance. At UNEP, we hope that the Inquiry can be one contribution to that end.

Achim Steiner  
Under-Secretary-General  
Executive Director, UNEP



## Aligning the Financial System with Sustainable Development – Highlights

**Considerable finance is needed to drive the transition to a green, inclusive economy.** A “clean trillion” of additional investment is needed annually up to 2030 to enable new infrastructure to be made green. More broadly is the need to reshape the financial system to extend its time horizons, reduce its appetite to invest in natural resource and carbon intensive assets, and to make investments that create livelihoods and jobs for all.

**Private capital is needed to finance this transition, complemented by public expenditure, but is currently being channelled into an unsustainable economy.** Traded financial capital globally amounts to US\$225 trillion, but little of this is being used to power the transition to a green and inclusive economy. Aligning the financial system to enable the long-term health of the real economy may require changes to its architecture, the ‘rules’ governing how it operates.

**Never in modern times has there been so great a consensus that the financial system is not fit for purpose.** The recent financial crisis, reinforced by the failure of today’s global economy to deliver the jobs needed and steward the natural environment, has eroded trust in the financial system’s capacity to serve its intended beneficiaries and the long-term interests of the real economy. Aligning the financial system to the needs of a green and inclusive economy is a pre-condition for achieving sustainable development, complementing policy and private action in the real economy.

**UNEP has established the ‘Inquiry into the Design of a Sustainable Financial System’ to address this high-potential policy arena.** Building on UNEP’s green economy initiative and two decades of work of the UNEP Finance Initiative, the Inquiry is being guided by a high-level Advisory Panel, and involves wide-reaching engagement and research at the national and international levels.

**The Inquiry aims to accelerate and scale emergent policy innovations that better align the financial system to sustainable development.** Growing numbers of central banks, financial regulators and private standards agencies, particularly from emerging economies, are advancing measures explicitly focused on green and equity goals. Broader policy debates, from concerns about short-termism and financial sector remuneration to housing finance have implications for aligning capital allocation to green and inclusive outcomes.

**Success of the Inquiry would establish the centrality of creating a sustainable financial system as an enabler of the transition to a green and inclusive economy, and policy options for achieving it.** Key is to place sustainability on the agenda of those who shape the financial system. This requires a portfolio of practical policy options, which might include new accounting standards, ways of addressing short-termism, integrating green factors into credit risk, new approaches to fiduciary responsibilities and more extensive mandates for central banks and financial regulators.

**The Inquiry’s approach to knowledge development is to draw on current practice, existing methods and analysis, leadership opinion, and forward-looking scenarios and policy proposals.** Building on the initial mapping and associated analysis and reflections, the Inquiry proposes to advance three workstreams focused on country experience, cross-cutting aspects of the financial system, and an enabling framework of scenarios, principles and assessment methods.

**The Inquiry will take an open approach that allows anyone to submit relevant learning, insights and ideas.** This will be enabled through its engagement in a number of countries, expert and stakeholder convenings, joint research and publications. This paper in an open invitation for those with expertise, interests and insights to contribute to the Inquiry’s work and outcomes.

# Key Questions for the Inquiry

The Inquiry's work will be shaped by a series of questions about the financial system set out below: a summary set of questions are listed on page 43

STARTING POINTS			
<b>DEFINITIONS</b> <ul style="list-style-type: none"> <li>▶ What are the critical elements that need clarification and communication to facilitate the convergence of the financial system and the green and inclusive economy?</li> <li>▶ What are the incentives that currently enable or disable the effective participation of financial actors in the transition to a green and inclusive economy?</li> <li>▶ How does financial market structure, including levels of concentration and ownership, impact environmental and social outcomes?</li> <li>▶ What are the relative merits of deploying financial over “real economy” policies and regulations to address environmental and equity issues and outcomes?</li> </ul>			
INNOVATION DIMENSION	EMPIRICAL QUESTIONS	ANALYSIS OF IMPLICATIONS	CONSIDERATION OF POLICY DESIGN OPTIONS
<b>TOMORROW'S FINANCIAL SYSTEM</b>	<ul style="list-style-type: none"> <li>▶ What are the emerging dynamics in the real economy which could be important for progress towards or away from a sustainable financial system?</li> <li>▶ What are the key disruptive factors that could shape the prospects for a sustainable financial system to 2020 and beyond?</li> </ul>	<ul style="list-style-type: none"> <li>▶ How might these emerging dynamics effect options for interventions in pursuit of a sustainable financial system?</li> <li>▶ How could technology and institutional innovations in the financial sector impact social and environmental outcomes?</li> </ul>	<ul style="list-style-type: none"> <li>▶ How do existing financial rules and regulations need to evolve in order not to hold back necessary green financial innovation?</li> <li>▶ What new financial frameworks are needed to encourage specifically green financial innovation, for example, in investing in ecosystem services?</li> <li>▶ How could different parts of government work together establish a coherent policy that could deliver a sustainable financial system?</li> </ul>
<b>SYSTEMS HORIZONS</b>	<ul style="list-style-type: none"> <li>▶ What is the relationship between long-term investment horizons and sustainability outcomes?</li> <li>▶ What is the impact of short-termism, short-term trading activity and intra-sector trading on environmental and equity outcomes?</li> </ul>	<ul style="list-style-type: none"> <li>▶ What steps are needed to fully integrate the sustainability dimension into the long-term investment agenda?</li> <li>▶ How can the scope of financial risk management effectively incorporate environmental and social factors at the system level?</li> </ul>	<ul style="list-style-type: none"> <li>▶ How can the short- and long-term dynamics of the financial system be reconciled with a green and inclusive green economy?</li> <li>▶ What are the policy and regulatory levers that can effectively reconcile the short- and long-term dynamics of the financial system with a green and inclusive economy?</li> </ul>
<b>SYSTEMS GOVERNANCE</b>	<ul style="list-style-type: none"> <li>▶ How do international finance governance institutions and processes take environmental and social issues into account?</li> <li>▶ How does analysis of systemic risk under macro-prudential regulation take environmental and social matters into account?</li> </ul>	<ul style="list-style-type: none"> <li>▶ What is the case for (and against) and practice of central banks and financial regulators directly and indirectly pursuing environmental and social objectives?</li> <li>▶ What are the key features of an assessment framework to evaluate financial policy measures for green economy impacts?</li> </ul>	<ul style="list-style-type: none"> <li>▶ How could the mandates for rule setters be updated to take account of the systemic risks associated with the financial system's impact on green and inclusivity outcomes, and vice versa?</li> <li>▶ What are the essential principles that should guide policy options for a sustainable financial system?</li> </ul>

INNOVATION DIMENSION	EMPIRICAL QUESTIONS	ANALYSIS OF IMPLICATIONS	CONSIDERATION OF POLICY DESIGN OPTIONS
	<ul style="list-style-type: none"> <li>▶ Do different configurations of financial policy and regulatory authorities impact their capacity to address environmental and social objectives?</li> </ul>	<ul style="list-style-type: none"> <li>▶ What are the leading experiences – and potential innovations – in the ways that different parts of government can work together to deliver a sustainable financial system?</li> <li>▶ What are the factors and mechanisms necessary to ensure accountability for the sustainability performance of the financial system to its ultimate beneficiaries?</li> </ul>	<ul style="list-style-type: none"> <li>▶ How could the ‘soft law’ principles that shape financial architecture best incorporate the green economy imperative?</li> </ul>
<b>RESPONSIBILITY, INFORMATION AND INCENTIVES</b>	<ul style="list-style-type: none"> <li>▶ How do investor governance and associated public policies take environmental and social matters into account?</li> <li>▶ What is the experience of extended goals and risk-assessment frameworks on performance, in both private and public financial institutions?</li> <li>▶ What is the level of fiscal support to the financial sector and its impacts on environmental and social outcomes?</li> <li>▶ What is the impact of differing forms of, and policy approaches to credit creation on environmental and social outcomes?</li> <li>▶ What impacts do existing private incentives (such as remuneration) have for the alignment of capital to a green, inclusive economy?</li> <li>▶ What are the market conditions under which information on green and inclusive outcomes becomes material to financial decision-makers?=-</li> </ul>	<ul style="list-style-type: none"> <li>▶ How important is the perceived gap between fundamental financial responsibilities (such as fiduciary duty) and sustainability factors?</li> <li>▶ How can the benchmarks and ratings that drive capital allocation become better aligned with the green economy?</li> <li>▶ How can the practice of disclosure by corporations, financial institutions and regulators evolve to strengthen market discipline for a sustainable financial system?</li> <li>▶ What is case for (and against) and practice of different approaches to policy-incentivized lending in addressing environmental and social objectives?</li> </ul>	<ul style="list-style-type: none"> <li>▶ What are the business models and governance arrangements that could best embed environmental, social and governance factors into the operations of financial institutions?</li> <li>▶ What are the most effective market and policy mechanisms to achieve alignment?</li> <li>▶ How could policy mechanisms and fiscal incentives for credit creation, savings, investment and pensions support the long-term transition to a green, inclusive economy?</li> </ul>

## CHANGE PATHWAYS

- ▶ How best can financial policy and regulatory aimed at environmental and social outcomes be sequenced and how can trade-offs be understood?
- ▶ How can decision-making structures at the national and international levels evolve to deliver joined up governance which aligns the financial system and the green economy?
- ▶ How will moves towards a sustainable financial system impact upon the competitiveness of nations and development of the world’s financial centres?
- ▶ What is the role of citizens as consumers, investors, employees and/or as social movements in effecting the financial system’s impact on environmental and social outcomes?





# 1

## HARNESSING THE FINANCIAL SYSTEM – THE INQUIRY’S RATIONALE & SCOPE

“WE ALSO REAFFIRM THE NEED TO ACHIEVE SUSTAINABLE DEVELOPMENT BY: PROMOTING SUSTAINED, INCLUSIVE AND EQUITABLE ECONOMIC GROWTH, CREATING GREATER OPPORTUNITIES FOR ALL, REDUCING INEQUALITIES, RAISING BASIC STANDARDS OF LIVING; FOSTERING EQUITABLE SOCIAL DEVELOPMENT AND INCLUSION; AND PROMOTING INTEGRATED AND SUSTAINABLE MANAGEMENT OF NATURAL RESOURCES AND ECOSYSTEMS THAT SUPPORTS INTER ALIA ECONOMIC, SOCIAL AND HUMAN DEVELOPMENT WHILE FACILITATING ECOSYSTEM CONSERVATION, REGENERATION AND RESTORATION AND RESILIENCE IN THE FACE OF NEW AND EMERGING CHALLENGES.”

UN, THE FUTURE WE WANT, 2012

### 1.1 The nexus of financial reform and the green, inclusive economy

**Considerable finance is needed to drive the transition to a green, inclusive economy.** Estimates indicate that around US\$1 trillion of additional investment is needed annually to 2030 to green new infrastructure in energy, transport, buildings and industry.<sup>1</sup> Such an amount, reasonably modest at roughly 1.5% of today’s global GDP, sits alongside the need to mobilize US\$5 trillion a year for the underlying investment. Further finance is needed for the “softer” investments in health and education, and to overcome the challenges to vulnerable communities from climate change, to ensure that all citizens can participate fully and benefit from tomorrow’s economy.<sup>2</sup>

**Governments will play a critical role in ensuring that such investments are made.** Public expenditure will play a crucial role, as it has historically in ensuring long-term investment to build today’s developed nations. Privately-held financial capital, equally, will need to be a major part of the solution, requiring that the investment logic of this capital can be aligned to the needs of the real economy.<sup>3</sup>

**The financial system is the means by which we can channel society’s collective financial assets to productive use.** Financially traded assets are valued at US\$225 trillion with further non-traded assets, such as real estate and businesses that are owned by individuals, communities and nations influenced by the financial system<sup>4</sup>. This capital, whilst largely privately owned, represents societies’ overall resource for investing in long-term development and well-being. It is now clear that the long-term health of the economy depends on underlying social and environmental systems, while the economy’s ‘footprint’ on these areas is in turn shaped by the dynamics of the financial system.<sup>5</sup>

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