Inquiry: Design of a Sustainable Financial System

UNEP

FINANCING FOR DEVELOPMENT

Aligning the Financial Systems in the Asia Pacific Region to Sustainable Development

ASIA-PACIFIC HIGH-LEVEL CONSULTATION ON FINANCING FOR DEVELOPMENT

April 2015, Jakarta

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 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 will publish its final report towards the end of 2015.

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

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This Briefing

This briefing has been produced by the UNEP Inquiry as a contribution to discussions a the Regional Consultation on Financing for Development in Asia and the Pacific taking place in Jakarta, Indonesia from 29-30 April 2015. It draws on the Inquiry's ongoing research, and country engagement as laid out in more detail in two recent publications Aligning the Financial System to Sustainable Development: Insights from Practice (2014) Aligning the Financial System to Sustainable Development: Pathways to Scale (2015), both available from *www.unep.org/inquiry/*.

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Errors and omissions remain the responsibility of the Inquiry.

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Foreword

As home to over half of the world's people, but much less than half of its natural resources, achieving inclusive, sustainable economic prosperity in the Asia-Pacific region depends on the health of the environment. Yet stocks of 'natural capital' (including non-renewable resources, forests, agricultural land and fisheries) are in decline across the region, and have dwindled by between third and a half in most countries of the region over the past five years.

Reversing this trend to realize sustainable development depends on finance flowing towards efficient, clean and inclusive economic activity and away from those activities that make the situation worse.

It is estimated that in the Asia-Pacific region some US$2.5 trillion is needed in annual investment for sustainable development – to close gaps in basic services and infrastructure and to protect the environment, enhance energy efficiency and respond to climate change. Further finance is needed for industrial upgrading, including by SMEs to enable more and better jobs to be created. As the 'zero draft' of the outcome document for the third International Conference on Financing for Development notes, innovative financial and capital market policies, regulations and standards that can align private capital flows to the financing needs of sustainable development will be crucial to mobilizing resources on this scale.

The region's savings, US$8.4 trillion in 2012, make up more than half of the world's total savings. Advancing sustainable financial systems can enhance the efficiency, effectiveness and resilience with which financial and capital markets channel these resources, delivering both returns to savers and the invesment needed for economic growth and transformation. Yet today only 0.8% of assets under management in the region are invested to according sustainability criteria. At the same time, in East Asia, 45% of adults lack access to the formal financial sector, and in South Asia the figure rises to 66%.

However, research and engagement by the UNEP Inquiry has found that the Asia-Pacific region is one of the most active in innovating towards a sustainable financial system. New green disclosure requirements are being adopted across banking and capital markets. Green credit guidelines are being introduced by banking regulators. Sustainability indexes and benchmarks are becoming established in securities markets, and credit rating agencies are beginning to incorporate climate risk into their solvency analyses. Innovations in micro-finance including mobile-money are seeking to close the gaps in access to finance.

Countries such as China, Indonesia and Japan are also demonstrating leadership in taking systematic approaches to developing and embedding green finance principles across the financial system. Putting sustainable development at the heart of financial and capital markets does not represent an 'additional' performance measure for Asia-Pacific's financial markets. Quite the contrary, it improves the availability of material information, enhances the all-important task of risk-pricing and advances the efficiency of credit and capital allocation.

This briefing developed by the UNEP Inquiry into the Design of Sustainable Financial System provides practical recommendations for the steps that countries can and are taking in the region to align financial governance, incentives regulation, policy and standards towards sustainable development.

But international cooperation is also crucial. In developing a new 'Global Framework for Financing Sustainable Development' through the Addis Ababa Accord, the international community could to include measures that seek to align the investment chain towards long-term performance and sustainability, recognizing that our prospects for success in achieving sustainable development goals depends on the this investment chain being effective, efficient and resilient.

Achim Steiner
Under-Secretary-General
Executive Director, UNEP

Summary

Adequate, appropriate finance is crucial for sustainable development in the Asia-Pacific region. The United Nations Economic and Social Commission for Asia and the Pacific UN (ESCAP) estimates that the region needs to invest around US$2.5 trillion a year between 2013 and 2030 to achieve key sustainable development goals:

- US$500-800 billion to close gaps in education, health, employment, social protection and basic access to energy services.
- US$800-$900 billion for developing infrastructure for energy, transport, telecommunications and water and sanitation.
- US$500-800 billion for climate change mitigation and renewable energy.

The region's developing financial and capital markets provide a unique opportunity for innovative financial and capital market policies, regulations and standards that can align private capital flows to the financing needs of sustainable development. Notably, the region's savings, US$8.4 trillion in 2012, represents more than half of the world's total savings, the channeling of which will make a significant difference to regional and international progress towards sustainable development.

Sustainable finance in Asia, as well as elsewhere, has to date mainly concerned the actions of individual financial institutions, sometimes encouraged and supported by voluntary associations and principles. But sustainable finance is more than a set of individual actions. Work has now entered the next phase of designing the key parameters for the financial system as a whole.

Advancing sustainable financial systems can enhance the efficiency, effectiveness and resilience of the region's financial and capital markets. Placing sustainable development at the heart of financial markets does not represent an 'additional' performance measure. Quite the contrary, it improves the availability of material information, enhances the all-important task of risk-pricing and advances the efficiency of credit and capital allocation. Moreover, by increasing the flow of finance into the enablers of a healthy dynamic, inclusive and sustainable economy, it secures higher, long-term, risk adjusted returns, and improves the resilience of the financial system itself.

The UNEP Inquiry into the Design of a Sustainable Financial System has identified clear potential roles of central bankers, financial regulators and financial policy makers in delivering financing for sustainable development, including specific examples from several countries in the region such as Bangladesh, China, Indonesia and Singapore.

Establishing national coordination mechanisms for ambitious, collective action is a critical enabler for advancing a sustainable financial system. National strategies and pathways for reform and innovation need to reflect particular needs and challenges. The region includes some of the world's largest and smallest, and wealthiest and poorest nations. Similarly its financial systems range from countries with small, under-developed banking communities to those with mature, internationalized capital markets and diversified, sophisticated financial actors. National coordination mechanisms include Indonesia's 'Roadmap for Sustainable Finance', China's recently established Green Finance Committee, overseen by the People's Bank of China, and Japan's working groups on Principles for 21st Century Finance.

International cooperation and coordinated action is key to advancing national and regional action for establishing sustainable financial systems. International financial governance remains fragmented, although the response to the global financial crisis demonstrated the will and capacity of the international community to act collectively and ambitiously. Shaping a sustainable financial system presents another opportunity for strong collective international action—action that could yield essential long-term sustainability benefits. The UN's Financing for Development process offers one means for enhanced international cooperation, to support the achievement of sustainable development goals. Beyond this, however, are a number of relevant international institutions responsible for macro-economic guidance and financial market development, which should be involved in setting the direction, pace and overall ambition and in establishing standards.

Options for Action

WHILE RECOGNIZING THE CONSIDERABLE DIVERSITY OF THE REGION, THE UNEP INQUIRY INTO THE DESIGN OF A SUSTAINABLE FINANCIAL SYSTEM HAS IDENTIFIED A PORTFOLIO OF DEVELOPMENTS AND POTENTIAL INNOVATIONS WORTHY OF CONSIDERATION BY ALL COUNTRIES IN THE REGION, INCLUDING:

1. **Sustainable banking**: Bangladesh, China and Indonesia have demonstrated the potential for establishing 'green credit' risk management and reporting requirements, offering green fiscal incentives and considering variations in capital weightings to account for mispriced environmental risks and broader policy needs.

2. **Policy-directed lending and investing**: Policy-directed lending and investing has a mixed performance record. Yet there is considerable opportunity across the region for blending commercial and policy objectives, given the widespread state ownership of both banks and investment vehicles such as sovereign wealth funds, as well as directed lending measures such as those pursued in India. In addition, consideration should be given to instilling more sophisticated, blended credit and investment allocation assessment approaches such as those practiced by leading sustainability investors and banks, –internationally, drawing also on the growing experience of values-based approaches practiced by the Islamic banking community.

3. **Green bonds**: With under-developed but fast growing bond markets, the region has the opportunity to lead in green bond issuance and benefit from the associated use of proceeds for green infrastructure and enterprise development, incentivizing their growing use through fiscal measures, as well as taking an active role in the development of international standards and associated green credit ratings.