

Inquiry: Design of a
Sustainable Financial System



ALIGNING
THE FINANCIAL
SYSTEM WITH
SUSTAINABLE
DEVELOPMENT

THE COMING FINANCIAL CLIMATE

THE INQUIRY'S 4TH PROGRESS REPORT

MAY 2015

ACROSS THE WORLD, A GROWING NUMBER OF GOVERNMENTS, REGULATORS, STANDARD-SETTERS AND MARKET ACTORS ARE STARTING TO INCORPORATE SUSTAINABILITY FACTORS INTO THE RULES THAT GOVERN THE FINANCIAL SYSTEM. The Inquiry was established in January 2014 to understand this fast-moving trend and to produce a set of policy options to advance good practice. Our work with a range of partners including central banks, financial institutions and international organisations has highlighted a diversity of catalysts and approaches across banking, capital markets, insurance and investment. In Brazil, integrating environmental and social factors into risk management is becoming viewed as a way of strengthening the resilience of the financial system. Better disclosure of environmental and social performance - for example through stock market and securities' requirements in Singapore and South Africa - is now seen as necessary to deliver market efficiency. And to serve lasting value creation in the real economy, work is underway to upgrade the effectiveness of the financial system, exemplified in the emergence of new principles, standards and incentives for the fast-moving 'green bond' market.

2015 LOOKS SET TO INTENSIFY THIS PROCESS AS GOVERNMENTS CONVERGE TO AGREE A GLOBAL FRAMEWORK FOR FINANCING SUSTAINABLE DEVELOPMENT. Critical steps include the Financing for Development conference in July, the launch of the new UN Sustainable Development Goals in September and the finalization of the UN Climate Change Conference in Paris. Across the Inquiry's work at both the country and international levels, harnessing the financial system to deliver climate security has emerged as a key cross-cutting issue. As a result, we are focusing this document - the Inquiry's fourth progress report - on financial reforms that can reduce the risks of high carbon assets, scale up capital for the low-carbon transition and invest in protecting economies from natural disasters and climate shocks.

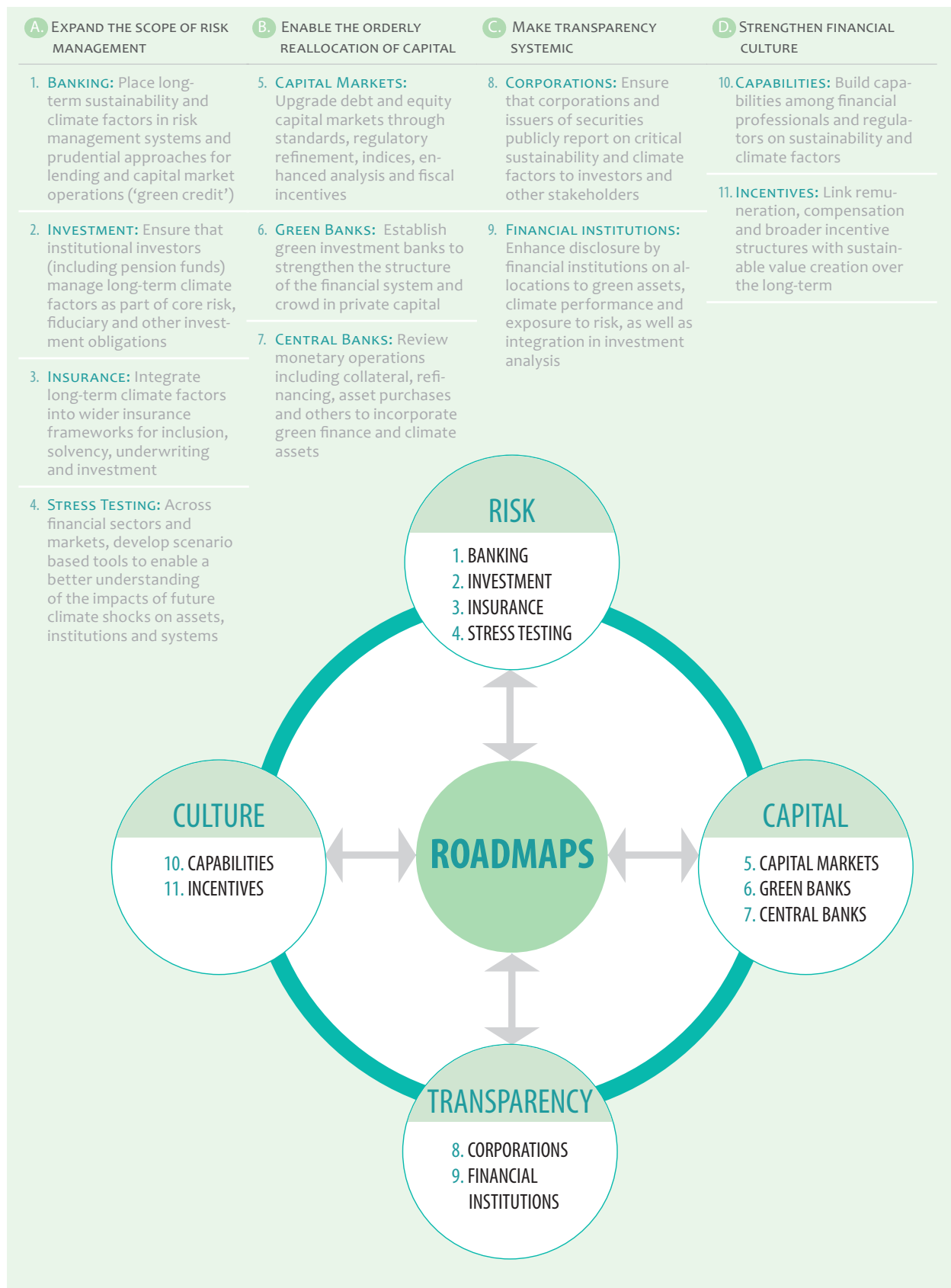
THE COSTS OF HIGH CARBON GROWTH INCLUDE SEVERE HEALTH IMPACTS AND DISRUPTION TO INFRASTRUCTURE, WATER AND FOOD SECURITY, ALL CONTRIBUTING TO INCREASING MARKET VOLATILITY, AS WELL AS LIVELIHOOD AND ECONOMIC IMPACTS, PARTICULARLY IN DEVELOPING COUNTRIES. In Kenya, for example, existing climate variability is already costing 2.4 per cent of GDP per year. In essence, market and policy failures have resulted in the structural mispricing of climate risks, exacerbated by short-termism, misaligned incentives and information asymmetries. This damage is expected to deepen - and risks becoming unmanageable if emissions of greenhouse gases are not reduced to net zero levels between 2055 and 2070.

A COMPREHENSIVE APPROACH TO FINANCING THIS TRANSITION IS REQUIRED. Stronger action is needed to drive the demand for green finance - for example, through carbon pricing and incentives for clean energy. Public finance will also be crucial but can only provide a portion of the capital required nationally and internationally. In China, annual investment in green industry could reach US\$320 billion in the next five years, with public finance estimated to provide no more than 10 to 15 percent of the total. To address this challenge, a task force, co-convened by the People's Bank of China and the Inquiry, has recently published a comprehensive set of recommendations for establishing China's 'green financial system'.

OUR FINDINGS POINT TO A NEW WAY OF THINKING AND PRACTICE THAT IS TAKING SHAPE. The task for those charged with governing the financial system is to enable the orderly transition from high- to low-carbon investments and also from vulnerable to resilient assets. This transition is already underway - for example, with global investments in renewable energy growing 17% in 2014, so that clean energy now makes up nearly half of net power capacity added worldwide. But the financial needs of low-carbon and resilient economy go far beyond renewables and require a system-wide response. As with all financial shifts, this is generating a set of transition risks for incumbent assets - risks that are not reflected in conventional models for delivering financial stability and so hold out the prospect of stranded assets.



PLACING THE FINANCING CHALLENGE AROUND CLIMATE CHANGE WITHIN THE BROADER CONTEXT OF THE GREEN ECONOMY AND SUSTAINABLE DEVELOPMENT IS ESSENTIAL TO MOBILISE THE TRILLIONS THAT ARE NEEDED. Drawing from the array of policy innovations at the country level, we have identified a set of measures that can make climate security part of the overall performance framework of a sustainable financial system. These covers risk, capital mobilization, transparency and culture. Each country will need to decide how these options relate to its financial system and the priorities for action.



POLICIES TO IMPROVE RISK MANAGEMENT AND PRUDENTIAL APPROACHES BY BANKS, INSURANCE COMPANIES AND INSTITUTIONAL INVESTORS ARE KEY. Examples include work by state insurance commissioners in the USA to improve disclosure of climate factors and a review of climate implications for the insurance sector being conducted by the Bank of England's Prudential Regulatory Authority. A range of policy tools is also available to mobilise capital. Beyond 'green bonds', the Inquiry's work in India has highlighted considerable scope for listed investment trusts (or 'yieldcos') for clean energy finance. Central banks can also target their monetary operations at the green economy, as the Bangladesh Bank is doing with its refinancing mechanisms.

IMPROVED REPORTING FRAMEWORKS OF SUSTAINABILITY AND CLIMATE FACTORS ARE ALSO CRITICAL TO ENSURE ACCOUNTABILITY. Market forces on their own have proved insufficient to deliver the necessary breadth, depth or consistency of corporate disclosure, prompting a proposal for a 'model reporting convention' in a submission to the Inquiry from the Climate Disclosure Standards Board (CDSB). Greater disclosure by financial institutions on green finance flows, carbon footprints and climate risk is also needed. To make this all happen, financial culture will need to be strengthened through improved skills and capabilities as well as by aligning incentives to sustainable value creation – both priorities that were highlighted in Switzerland's contribution to the Inquiry.

REINFORCING THE FINANCIAL SYSTEM IN THESE WAYS IS A STRATEGIC EXERCISE THAT WILL INVOLVE SUSTAINED EFFORT. At the national level, the introduction of long-term strategies, roadmaps and national coordination mechanisms can have important signalling effects, building market confidence in long-term policy direction. Indonesia's financial regulator, OJK, for example, has developed a comprehensive Roadmap for Sustainable Finance, containing a package of measures to be sequenced over the next decade.

BASED ON THIS BOTTOM-UP EXPERIMENTATION AT THE COUNTRY LEVEL, A NUMBER OF PROMISING AVENUES FOR INTERNATIONAL COOPERATION ARE NOW OPENING UP. This could help to evaluate the impacts of existing initiatives, share good practice and ensure coherence with international regimes. Beyond the formal negotiations under the UN Framework Convention on Climate Change, discussions are now underway on how to reflect climate factors in the global financial architecture. For example, the G20 Finance Ministers and Central Bank governors have asked the Financial Stability Board to explore how the financial sector could address climate issues. Other opportunities include the potential for collaborative research among central banks, efforts to link national innovations with the Basel banking accords and coordination among securities' regulators and accounting standards bodies to bring coherence to climate reporting.

ACTIONS SUCH AS THESE WILL NOT JUST STRENGTHEN CLIMATE SECURITY – THEY WILL ALSO CONTRIBUTE TO A MORE EFFICIENT, EFFECTIVE AND RESILIENT FINANCIAL SYSTEM. Initial efforts both to remove barriers in the financial system that could hold back the transition, as well as leverage its innovative potential are underway. The outlines of a financial system that contributes to keeping global warming to below 2°C are becoming clear and are set to be deepened in the years ahead. At a time of weak global growth, low interest rates and unmet needs, a concerted approach to channeling capital to the next wave of infrastructure and innovation makes strategic sense. This is the coming financial climate.



More information on the Inquiry, including the references cited in this summary as well as the full version of this report, can be found at:

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