Inquiry: Design of a Sustainable Financial System

SUSTAINABLE FINANCE LAB

UNEP

Design of a Sustainable Financial System

NETHERLANDS INPUT TO THE UNEP INQUIRY

OCTOBER 2015

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 published its final report in October 2015.

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

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Introduction

In 2014, the United Nations Environment Programme (UNEP) initiated the Inquiry into the Design of a Sustainable Financial System. The Inquiry is intended to accelerate the transition to a green and circular economy by better aligning the financial system through identifying best practices and exploring financial market policy and regulatory innovations. The Inquiry will do this through an advisory council, practitioner dialogue and research.

Financial sector experts from several countries have provided inputs to the Inquiry. The Sustainable Finance Lab, sponsored by the Dutch Ministry of Infrastructure and the Environment, the Netherlands Development Finance Company (FMO) and nine other private financial institutions, invited the Inquiry's co-director Simon Zadek to a meeting on 26 May 2015 with 20 representatives from the Dutch financial sector (see annex for the list) ranging from public policymakers and regulators to the largest banks, asset managers, insurance companies and sustainable frontrunners. A follow-up meeting will take place on 27 November 2015, hosted by Klaas Knot, President of the Dutch Central Bank (DNB).

This note summarizes the input provided to the Inquiry, including best practices, financial market policy and regulatory innovations to help bring about the green economy and a sustainable financial sector. It should be noted that the policy recommendations contained in this note were not formally endorsed by all meeting participants or their institutions.

On the need for finance to become more involved in the sustainability transition

As highlighted by the Inquiry, we are currently overinvesting in economic activities with too many negative social and environmental externalities and underinvesting in economic activities that deliver on urgent social and ecological needs.

The current credit and investment portfolios are predominantly in the old linear economy. The coming decades will see a transition to a more green and circular economy. The financial sector will need to fulfil its fiduciary duties and ensure that the financial system is ready for this transition.

Several Dutch financial institutions have recently set ambitious targets:

- The pension fund for the healthcare sector PFZW set a goal to halve the carbon emissions of its portfolio by 2020 and raise its impact investments of 3% to 12%.
- The ASN Bank aims to be climate neutral with all its investments by 2030.[1]
- The development bank FMO has set an objective for 2020 to double its impact and halve its carbon footprint.
- Rabobank targets a sustainable food system.
- APG has committed to doubling its renewable energy investment by 2017.

On the financial risk

Ecological and social imbalances pose a real and growing threat that could destabilize the global economy and its financiers. This is increasingly recognized, for instance by the current prudential investigation by the Bank of England and by the G20 request to the Financial Stability Board to consider how central banks should assess climate-related risks to financial stability.

In the Netherlands the investment organization of ABP, the Dutch pension fund for civil servants and teachers, has analysed the risk exposure of its investments stemming from stricter government measures to combat climate change.

Dutch banks are also increasingly integrating environmental, social and governance (ESG) issues into their credit decisions and risk models, defining an ESG-risk appetite like ABN AMRO Bank and ING have done. This has meant moving away from excluding the worst offenders to recognizing the sustainability leaders.[2]

However, much is still to be learned in this process. First, there is a data problem. Which companies and projects carry which risk? Carbon accounting is still in an early phase. Aggregated data across industries is needed. The recent announcement by the French Government of forthcoming legislation that would mandate carbon disclosure by major companies could help in this regard.

Next, scenarios are needed that show how different social and environmental factors might impact all assets. At the moment, environmental stress testing is mostly limited to the effect on the fossil fuel companies and not the wider economy.

This data is needed to convince the risk modellers, the credit commissions of financial institutions and the regulators to be more pro-active in this field. Only then can the full effect of ecological tensions on financial risk be recognized fully and translated into the pricing of loans and investments. Only then can frontrunners in the field of ESG be rewarded for their efforts and the financial market transformed into a true driving force for change. However, current regulations like Solvency 2 and Basel 3 limit making this distinction between corporates and projects with a lower risk due to better ecological performance.

On the financial return

Consideration of risk reduction is not the only means for raising the ESG-awareness of financial institutions. The transition to a sustainable economy will shape the global economy in the decades to come. Anticipating this change and getting ahead of the crowd offers great opportunities.

Banks understand this, as their customers increasingly ask them for new products that better fit the changing business landscape, such as the new business models required for the circular economy.[3]

Asset managers also increasingly find that sustainable investments offer a good return. Especially worthwhile are investments in companies that improve their ESG performance, as this adds to their value. Investors can play a role in this transformation through their active engagement.

While the financial sector needs to adapt to the demand of frontrunners in the sustainability field, the practitioners of the circular economy also need to adapt in order to tap into the financial potential. Investors often struggle to fulfill their mandate in ESG investments due to a lack of investable projects and companies. Needed are templates and standards for making existing real estate more energy efficient. In the Netherlands, the Dutch Investment Institution (NLII), a joint effort of the government and private sector, is advancing this work.

On the values approach

While it is important to better capture the ESG risks and returns, this alone will not suffice. Fundamental values cannot be integrated into the financial models, or integrated only to a limited extent. Take the example of the carbon bubble risk. This can be mitigated by either reducing the investments in fossil fuels (and hence the risk of catastrophic climate change) or by lobbying against public policies aimed at reducing greenhouse gas emissions. From a (short-term) risk perspective these might be the same, from a values perspective they are not.

If ESG is only taken into account as an investment or financial risk, we will not end up in a sustainable society. Many risks are not financially valued (loss of ecosystem services, poverty etc.) or are externalized to parts of society that cannot speak out (the poor, future generations). By the time that, for example, climate change becomes a financial risk, it is too late because the damage is irreversible. A pure risk approach thus falls short.

Therefore, next to risk and return, the financial sector needs to also implement a values approach. This has been recognized by the Dutch financial sector, for instance by being a driving force for the setting of global standards in this field, like the Equator principles, the Principles for Responsible Investment and the Principles for Sustainable Insurance. Recently the Dutch banking sector adopted its 'societal statute' in which the banks define their role in society as helping society overcome the challenges in the field of climate change and health care. In addition, all Dutch bankers have pledged from this year onwards to carefully balance the interests of all stakeholders of the bank: its employees, shareholders, clients and society at large.

Also important is the intrinsic motivation of the people working in, and especially those leading, the financial institutions. Boards and regulators of financial institutions need to ensure that there is enough expertise and motivation on ESG at all levels of the financial institutions. ESG should not be confined to a separate directorate. The Dutch central bank (DNB) has started a program on culture and behaviour in financial institutions and reflects this in their qualifications for potential board members.

A values approach also requires a more intensive dialogue with customers, both the ones with personal savings and the major companies that are financed or invested in. People need to be engaged and included in a meaningful discussion. For this, financial institutions need to be sufficiently transparent, including for the non-financial impact of their activities.

On the role of regulation and regulators

Regulators play an important role in allowing and stimulating the financial sector to finance the transition to a sustainable economy. This also fits their mandate, as failing to make this transition will lead to an unstable society and economy, and hence an unstable financial sector.[4]

A first step would be to understand which unintended consequences of the post-2008 reform agenda might be hindering a more sustainable financial system. We already mentioned the limited room within Solvency 2 and Basel 3 to differentiate risk weights and hence capital requirements based on ESG factors. More long term, illiquid investments also get higher capital charges, and are thus discouraged by the new regulations.

Other regulations hindering sustainable finance are the use of short-term models to evaluate the solvency of asset managers and the use of market wide benchmarks. This makes it hard to build a portfolio of companies that may ultimately prove to be more stable and provide a higher return, but may also require more spending on investments because they are not currently valued as such by a myopic market. The steadfast belief in perfect markets and the value of spreading assets to reduce risk, in combination with the emphasis on cost reduction, increase the push towards passive investing. For small investors, like small pension funds, a 'green index' may be the most sensible way. However, more impactful ways of investing require a more active approach that may lead to more concentrated portfolios. Balancing a (much) lower environmental risk against a (little) higher concentration risk or a lower liquidity is difficult within the current supervisory framework.

Also, regulation meant to protect the financial consumer may be counterproductive, making it practically impossible for retail investors to participate in impact investing.[5] As a result they are stuck with the obligation to either invest their money in regular assets that expose them to higher ESG risks. Or they may engage in peer-to-peer finance, like crowdfunding, where they are not advised by a financial professional, increasing their credit risk exposure.

Regulators indicate that these issues have been raised before, but what is still lacking is a more detailed case description of how current regulation actually hinders sustainable finance. A step forward would be to collect clear cases where the tensions between sustainable banking and investing and the regulatory framework arise.

Regulators should also create more transparency and share best practices on ESG in their supervisory role. Here, a principle-based approach is preferred to a more rule-based approach.

A noteworthy Dutch example is the Green Funds Scheme, a tax incentive scheme launched in 1995 to encourage individual investors to put money into projects that benefit nature and the environment. It sets technical and financial conditions, but the main requirement is that these new projects provide a significant and immediate environmental benefit. Generally these projects range from environmentally friendly greenhouses and wind turbines to organic farming and afforestation. Individuals who invest in a green fund receive a lower rate than the market interest rate (generally 1% lower), however this is compensated by the tax advantage. The Dutch Ministry of Housing, Spatial Planning and the Environment found, in a 2010 report, that in 2010 alone around a quarter of a million investors have put up €7 billion, enabling 6,000 green projects to be funded.[6]

On the Dutch approach

'The train has left the station' – the global financial sector is making the transition to a sustainable sector, emerging countries are adopting promising approaches.

The Netherlands has a rich history of understanding the complex interrelationship between the environment, the economy and the well-being of its citizens. Being, for a large part, located below sea level and bordering the sea, the Dutch have always worked together to keep the land dry and safe. In addition, the importance of social cohesion has long been recognized, as the Netherlands is one of the most densely populated countries of the world.

The Dutch have developed a character of cooperation, and accompanying institutions ranging from platforms for regular discussion amongst potential adversaries, like employers and employees, to international institutions for peace and justice, like the International Court of Justice and the International Criminal Court.

This 'poldermodel' is also proving its worth in the sustainability transition. In 2013 more than 40 organizations agreed upon a national accord on energy. All major Dutch banks will now cooperate to remove obstacles in finance for investments in renewable energy and energy efficiency.

Currently the financial sector is discussing with the government and other stakeholders a covenant/agreement in which they will detail how to work with ESG risks.

The Dutch presidency of the EU in the first half of 2016 has the circular economy as one of its priorities and intends to advance the proposals in this field that the European Commission is expected to launch later this year.[7] Special attention could be given to the financing of the circular economy. Also, this could be linked to the Commission's work in the field of long-term investing by for example building on recent efforts by the Dutch pension funds to enhance the enabling environment for investing in solutions to sustainable development challenges.

ENDNOTES

1 See ASN Bank Carbon loss and profit methodology, available at: http://www.asnbank.nl/web/file?uuid=253a41c9-4446-47c6-8bdc-b2ba5201ea14&owner=9ccef6a9-c451-451a-963a-e931fe46c086&contentid=3309, and http://www.asnbank.nl/particulier/wat-doen-wij/waar-kiezen-we-voor/duurzaamheidsbeleid/klimaat/klimaatneutraal-in-2030.html#EN.

2 See for example ING's sustainability approach to lending, available at: http://www.ing.com/ING-in-Society/Sustainability/Sustainability-news/Sustainability-approach-to-lending-will-futureproof-our-business-and-yours-too.htm

3 ING (2015) Rethinking finance in a circular economy. Available at: http://www.ing.com/web/file?uuid=94261282-eed1-40b4-9d98-b333009aeca0&owner=b03bc017-e0db-4b5d-abbf-003b12934429&contentid=34276

4 Schoenmaker, D., van Tilburg, R. and Wijffels, H. (2015) What role for supervisors in addressing systemic environmental risk? Available at: http://sustainablefinancelab.nl/files/2015/04/Working-paper-15-april.pdf

5 Triodos bank (2014) Impact investing for everyone. Available at: http://www.socialimpactinvestment.org/reports/Triodos-Bank-report-on-Impact-investing.pdf

6 The green funds scheme – a success story in the making. Ministry of Housing, Spatial Planning and the Environment, 2010.

7 See http://ec.europa.eu/environment/circular-economy/index_en.htm.

ANNEX: LIST OF PARTICIPANTS

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