Inquiry: Design of a Sustainable Financial System

IISD
International Institute for Sustainable Development

Bangladesh Bank

UNEP

Designing a Sustainable Financial System in Bangladesh

SUMMARY BRIEFING

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 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 summary paper is condensed from a longer technical report applying the Inquiry's framework on the design of a sustainable financial system to the context of Bangladesh. It has been produced by the Inquiry together with the Bangladesh Bank and the International Institute for Sustainable Development (IISD).

The team involved in developing the report included Mark Halle and Mariana Hug Silva from IISD, Dr. Md. Habibur Rahman from the Bangladesh Bank, and Dr. Shah Mhd. Ahsan Habib from the Bangladesh Institute of Bank Management, and Simon Zadek and Maya Forstater of the UNEP Inquiry. It is based on the UNEP Inquiry's analytical framework, desk research and interviews carried out in Bangladesh.

This paper also builds on the findings of an earlier study for the Inquiry on Bangladesh by Alex Barkawi and Pierre Monnin of the Council on Economic Policies entitled 'Monetary Policy and Sustainability - the Case of Bangladesh'.

Comments are welcome and should be sent to *simon.zadek@unep.org*

Acknowledgements

This report benefited from interviews with experts and practitioners at the Bangladesh Bank, commercial banks and non-banking financial institutions, key civil society leaders, the Dhaka stock exchange, insurance companies and insurance regulators, research and teaching institutions, and international development cooperation partners. Two field visits were conducted – one to a biogas scheme in a rural area and another to a model textile and garment factory in Narayanganj. We are grateful to all the interviewees and hosts for their inputs.

FOREWORD

At the Bangladesh Bank, we take our responsibilities very seriously. We are tasked like many other central banks to ensure macroeconomic and monetary stability, perform regulatory functions, and to ensure the orderly conduct of foreign exchange and other markets. In addition, however, we are also mandated to support rapid broad based inclusive economic growth, employment generation and poverty eradication in Bangladesh. Actually, we do not see these conventional functions and broader developmental mandate as being in conflict. Quite the reverse, we see them as essential complements, in fact the mirror image of each other.

Today, we are part of a growing community that shares our vision of a developmental approach to central banking. The UNEP Inquiry has done us the service of setting out for the first time the growing scale and innovation of this community, and its potential to shape financial and capital markets in ways that support efforts to achieve sustainable development. Moreover, the Inquiry highlights the important leadership role played by developing countries in exploring how to make social and environmental considerations count in financial decision-making. From Kenya to Colombia, and from China to Indonesia and Peru, we are seeing efforts to instil national development priorities into the core of our respective financial systems.

There is a long way to go, much to be done at the national and international levels. It is crucial to share lessons and cooperate in joint action.

This short paper, prepared with the International Institute for Sustainable Development (IISD) and the UNEP Inquiry, is a contribution to this process. We are convinced that our actions have delivered considerable gains for Bangladesh, and can provide insights relevant elsewhere. Likewise, we have much to learn from others, and look forward to engaging with our counterparts.

Dr Atiur Rahman
Governor, Bangladesh Bank

SUMMARY

Innovations in policies, regulations and norms to shape a greener and more inclusive financial system are emerging in many places, but particularly in developing and emerging economies. Bangladesh has been a leader in this regard, as part of a sustained drive to ingrain a socially responsible institutional ethos in the financial sector. In particular it has developed a suite of green banking regulations and policies including concessional green refinancing, credit quotas for green finance and guidance and requirements on environmental due diligence.

While there has not been an assessment of the impact of these policies, regular monitoring provides an insight into the scale of associated financial flows:

- 1 billion Taka (US$13 million) of green refinancing was disbursed during FY10-FY14
- 44 billion Taka (US$0.5 billion) of loans were disbursed to key green sectors in 2014
- 354 billion Taka (US$4.5 billion) of loans were disbursed to industrial facilities with effluent treatment in 2014 ('indirect green financing')
- 1,581 billion Taka (US$20 billion) of loans were disbursed to high impact sectors where environmental due diligence had been carried out

Green finance is growing but it remains modest compared to the scale of Bangladesh's environmental, energy and industrial development imperatives. This paper provides initial ideas towards a national roadmap which could be developed with leadership and involvement not only of the Bangladesh Bank but also other financial regulators, financial institutions, the microcredit industry, civil society, stock exchanges, credit ratings and private standard setters. Key steps include:

- Enhancing market practice –The practice of environmental risk management should be reviewed and continually strengthened. A protocol could also be developed to support assessment of clean energy and energy efficiency investments. Further advancements in information disclosure by listed companies and development of standards for green bonds would widen green finance beyond the banks.
- Leveraging private capital with public finance – The refinancing scheme should be assessed to establish where course corrections or new approaches might be warranted. Fiscal incentives might also be targeted to encourage the creation of long-term savings product and to provide credit enhancement to kick-start the development of a green bond market.
- Directing finance through policy - There is potential for greening SME Credit Policies and tightening green credit quotas to target specific areas such as solar energy and energy efficiency loans.
- Encouraging cultural transformation – Networks of green banking competency should continue to be built up. Further opportunities include exploring the linkages between Islamic banking and sustainable development and promoting a green investor's network.
- Upgrading governance architecture – This could include aligning monetary targets with sustainability objectives, integrating green finance in the 7th five-year plan and establishing a green finance committee.

These measures, concentrated on the financial system would be complementary to real economy measures such as environmental regulations and fossil fuel subsidy reform. It is a bold and exciting agenda, but also one that is practically achievable. Broadly speaking, action in the banking sector might be implemented most rapidly, with measures for debt and equity markets, institutional investment and insurance being developed as part of the broader growth in these markets.

1 INTRODUCTION

Around the world, it is increasingly being recognized that the full potential of the financial system needs to be harnessed to deliver the transition to sustainable development. Policies, regulations and norms must shape more stable and efficient financial systems that are also more connected to the mainstream economy and the social and environmental challenges it faces.

The UNEP Inquiry has found that such policy innovations are evolving most strongly from developing and emerging economies. These countries are faced with immediate and material social and environmental challenges, and their financial systems are less constrained by prevailing norms and interests. Notably, institutions responsible for governing developing country financial and capital markets are more accustomed than their developed country peers to responding to policy signals and national development priorities.

Box 1: UNEP Inquiry Findings

The findings of the UNEP Inquiry are published in its global report The Financial System We Need: Aligning the Financial System with Sustainable Development

This study has been informed by country studies carried out with local and international partners including in Bangladesh, Brazil, China, Colombia, France, Kenya, India, Indonesia, the Netherlands, Switzerland, South Africa, the UK and the US, as well as other international and thematic research.

These are available at *www.unep.org/inquiry* and *www.unepinquiry.org*

In Bangladesh the central bank has played a leadership role in pursuing sustainability priorities within its mandate of maintaining monetary and currency stability in order to foster growth and development in the national interest. As a part of ongoing financial sector reform there is a concerted effort not just to deepen the financial system and make it more efficient and inclusive, but also to make it greener. Bangladesh has sought to align regulation and policy to national goals, while avoiding negative unintended impacts. The approach has not been to force financial institutions, but to encourage and develop the business case.

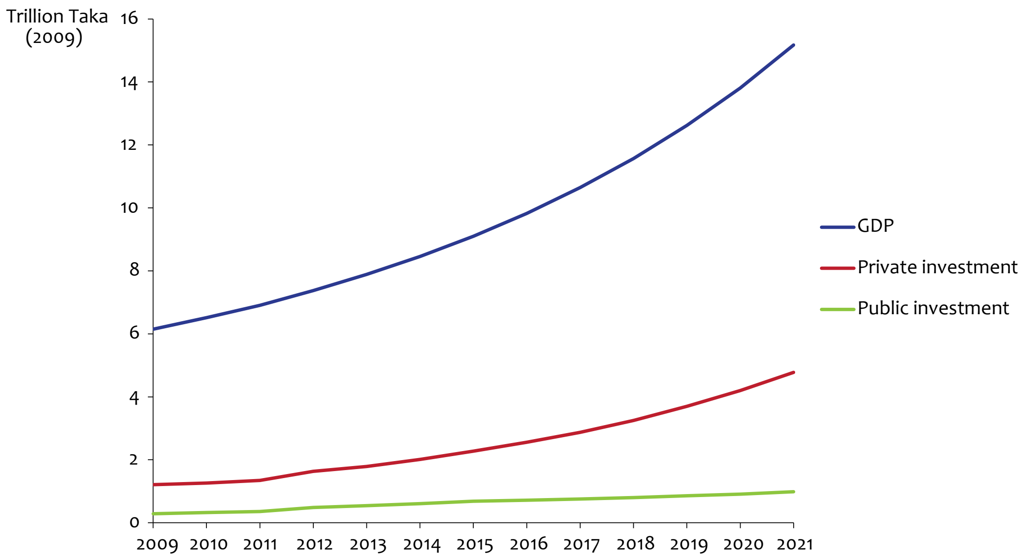
This paper focuses on the steps that Bangladesh is taking, and could take, through regulation, policy and private action focused on the financial system. These financial instruments are complementary to other necessary policy measures, regulations and incentives in the real economy, such as reviews of subsidies, and the provision of fiscal incentives and tax exemptions for green technologies.[1]

1.1 Bangladesh's vision for sustainable development

Bangladesh's vision for a prosperous future ('Vision 2021') highlights that it is a nation endowed with enormous potential that is yet to be realized. It is seeking to transform from a low-income economy to the first stages of a middle-income economy over the decade from 2010, through enhanced and sustainable agricultural production, accelerated industrialization and increasing integration into the global economy. At the same time it must address critical energy supply and infrastructure gaps, handle rapid urbanization and address vulnerability to floods, cyclones, storm surges and drought.[2] The nation's aspirations are based on a vision of increased investment (targeted to rise from 24% to 38% of GDP over the decade). While some of this will be public investment to address infrastructure gaps, the greatest rise is in private investment, from 1.2 trillion Taka (US$15 billion) in 2010 to 4.8 trillion Taka (US$61 billion) by 2021.

The financial sector must play a key role in enabling investment, providing inclusive access to finance and ensuring that such investment is sensitized and aligned to Bangladesh's environmental challenges in key areas such as agriculture, energy, transport and industry. At the same time the demands of Bangladesh's export partners for socially and environmentally responsible production continue to grow; this suggests that success in attracting much needed foreign investment will also be linked to rising expectations of sustainable industry. For all these reasons, the topic of how the financial system can best be harnessed to ensure that sustainable growth for Bangladesh has moved to centre stage.

FIGURE 1: GROWTH AND INVESTMENT TARGETS IN VISION 2021



Source: based on data from Vision 2021, Perspective Plan

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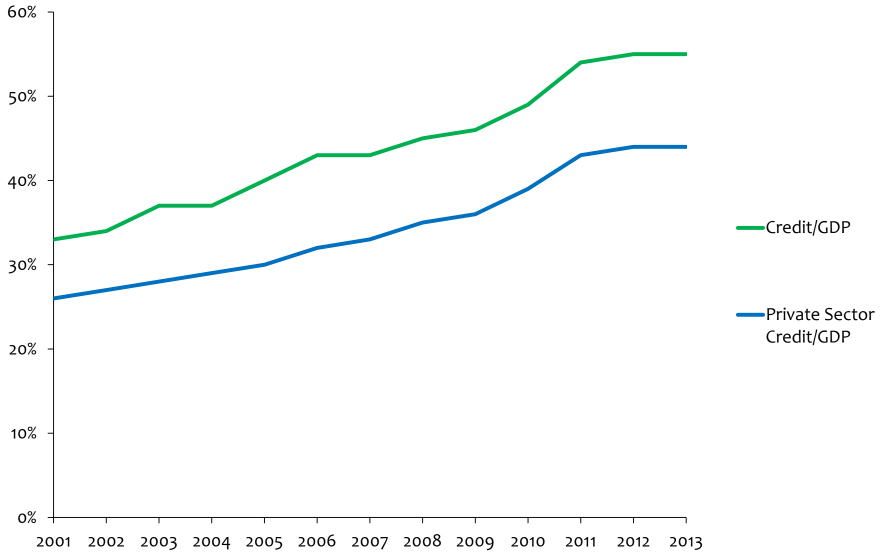
1.2 FINANCIAL DEVELOPMENT

Bangladesh's financial system has undergone two decades of reform, enabling marked progress in the mobilization of savings and the growth of credit to the private sector (see Figure 2). Bangladesh's financial system is bank-dominated, with 56 banks with assets totalling 8 trillion Taka (US$100 billion), including 4.2 trillion Taka of loans and advances.[3] 62% of assets are held by private commercial banks, 26% by state-owned commercial banks and 6% each by state-owned development finance institutions, and 6% by foreign commercial banks. The sector has been strengthened through diversification and greater market orientation. While financial reforms have strengthened the performance of the banks, they remain constrained by tradition and risk aversion, and are focused mainly on providing loans based on collateral or for working capital. Non-banking financial institutions such as leasing companies also play an increasingly important part in the financial system. There have also been institutional and regulatory changes in the capital market, with two stock exchanges. However the bond market remains dominated by fixed income government debt instruments and the corporate bond market is at a nascent stage. This lack of long-term savings and investment vehicles impacts on infrastructure financing, especially investments in power and housing.

Notable progress has been made in promoting greater financial inclusion.[4] Bangladesh has been a leading innovator in the development of microfinance and these loans are now equal to 3% of GDP. Currently, four out of five households in Bangladesh have access to financial services mainly because of the improvements in the networks of banks and microfinance institutions as well as a booming mobile banking segment. Access to financial services, including insurance, stood at over 79% in 2014 and continues to grow.[5]

Figure 2: Financial Deepening in Bangladesh



Source: based on Muqtada (2015)[6]

Box 2: Policies to advance financial inclusion in Bangladesh

Bangladesh has been at the heart of the development of microfinance over several decades with many small and large players involved. However, financial inclusion of its largely rural population remains a key challenge. In 2013, the Bangladesh Bank implemented several policies to promote access to finance by vulnerable populations, small farmers and SMEs. This included requiring all banks to provide rural credit and '10 Taka' accounts available with a minimum initial deposit equivalent to US$0.12 and to open one rural branch for every new urban branch. These requirements were backed up by provision of concessional refinancing.[7]

Technology has played a key role in broadening access to finance, including through the development of online access to the Credit Information Bureau (CIB) and national automated payment clearing system.[8] One private sector-led initiative for financial inclusion is bKash the country's fastest growing mobile money provider.[9] It is a joint venture of BRAC Bank and Money in Motion LLC, USA with investment from the Bill & Melinda Gates Foundation and the IFC. The Bangladesh Bank played a role by allowing bKash sufficient regulatory space to create a new line of business while still remaining within the broader umbrella of the BRAC Bank.

2 INITIAL LEADERSHIP IN DEVELOPING A GREEN FINANCIAL SYSTEM

The Bangladesh Bank (BB) has played a leading role in driving developments in green finance, developing new policies and integrating green criteria into its existing operations. There are three key policies: green refinancing, green banking guidelines, and a credit quota for loans. These policies interact with both commercial and state owned financial institutions, and in some cases also community level NGOs (see box 3).

2.1 Green Refinancing

The Bangladesh Bank has a broader policy of targeted refinancing lines to commercial banks at reduced interest rates for loans given to priority segments of the economy including agriculture and garment exporters. The refinancing window provides concessional credit but uses commercial banks as a gatekeeper in the allocation of capital. The default risk remains with the banking sector. In 2009, the Bangladesh Bank launched a green refinancing line with an initial focus on solar energy, biogas, and waste treatment projects; its scope has continuously been expanded and now covers 47 items, with 2 billion Taka (US$25 million) available for commercial banks to disburse loans to key green sectors. Loans are provided at 5% with interest chargeable to bank customers capped at 9%. In addition there is a US$50 million ADB-financed refinancing program for more efficient brick kilns.

In February 2015, the Bangladesh Bank announced its intention to create a new longer term refinancing window to provide US$500 million of funding of which US$200 million will be allocated specifically for green initiatives including water and energy use efficiency measures in the textiles industry.

In addition to banks, non-bank financial institutions such as the state owned Infrastructure Development Company Limited (IDCOL) play a key role in intermediating refinancing to enable households to purchase solar home energy systems, domestic biogas, solar irrigation systems and solar mini-grids. IDCOL combines concessional refinancing to microfinance institutions and with technology assessments, quality control, monitoring and other support services.

2.2 Policy Guidelines for Green Banking

In 2011 the Bangladesh Bank issued Policy Guidelines for Green Banking.[10] These called on all commercial banks to adopt a comprehensive Green Banking policy over three phases:[11]

Phase one

- Develop an environment policy covering its own buildings and facilities and lending policies.
- Establish a green banking unit, and a high-level committee entrusted with reviewing the bank's environmental policies, strategies and programs.
- Allocate budget lines for green finance, climate risk and internal capacity building.

Phase two

- Formulate specific policies and targets for environmentally-sensitive sectors.
- Public reporting on steps taken.
- Set up 'green branches' (e.g. solar powered buildings) and increase use of video conferencing.
- Develop an environmental risk management manual for assessment and monitoring of projects and working capital loans.

Phase three

- Publish independently assured Green Annual Reports.

The Bangladesh Bank provides support such as Guidelines on Environmental Risk Management including a sector-specific 'Environmental Due-diligence Checklist' for financing environmentally sensitive sectors. An incentive is provided for banks undertaking the Green Banking Guidelines, in terms of awarding of points for the management component of the bank supervisory rating. The Bangladesh Bank also issues an annual declaration of the top ten performers in key areas of green banking and has pledged to include green banking practices when considering applications for licenses to open new bank branches.

2.3 Credit quotas

Further instruments used by the Bangladesh Bank include mandatory credit quotas as well as maximum debt-to-equity-ratios. The central bank encourages commercial banks to give at least 2.5% of total loans to the agricultural sector, and in 2015 it announced requirements would be introduced that at least 5% of its loan portfolio goes to green finance.

Box 3: The role of civil society organizations in supporting green finance

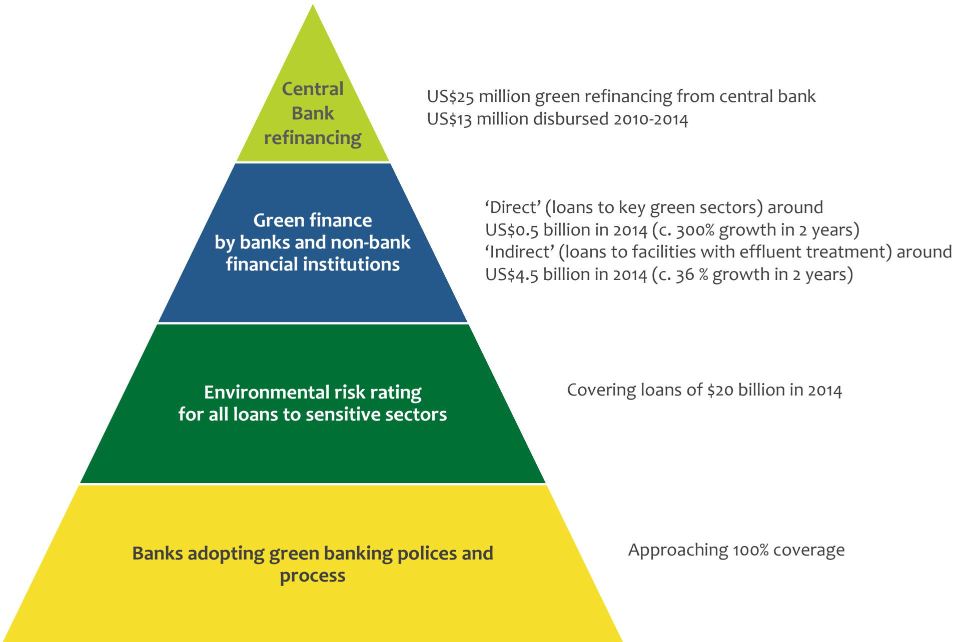
Bangladesh has long been known as a pioneer in finance for rural development and institutions such as Grameen Bank and BRAC combine social missions with banking and microfinance services. Many other smaller NGOs operate in a single district or area, offering a range of services to local communities. Few countries have such a dense coverage of development services as Bangladesh. This dense network has significant potential for green finance, offering technical support, monitoring, quality assurance and troubleshooting for small-scale green loans. Banks are also increasingly working in partnership with local NGOs. Through the Bangladesh Bank's green refinancing scheme, the Trust Bank, in partnership with a local rural development NGO SOJAG, is supporting a farm-level biogas development project. Based on cattle bought through the credit scheme, the participating farms build a biogas digester and use the resulting methane to cook, thus lowering their need for firewood and greatly increasing the health of the women in the family. Often, the producers can sell their surplus and turn the biogas into an income stream.

3 IMPACT AND EXPERIENCE TO DATE

3.1 Monitoring uptake

In 2012, the Bangladesh Bank issued guidance to banks on the reporting of green banking activities. It collates this data into quarterly reports, and in 2014 included a chapter on sustainable banking in its annual report. The figures reflect a cascade from small amounts of public finance to larger amounts of targeted green investment, to loans subject to environmental due diligence and the adoption of green banking practices and policies by banks as a whole.

Figure 3: Cascade of green finance flows and behaviours



Source: UNEP Inquiry, based on data from Bangladesh Bank

Working up from the bottom:

- **The number of banks establishing green banking units and policies and undertaking reporting** has steadily increased, and is approaching 100 per cent. The policies tend to be a direct replication of the Bangladesh Bank guidance.

- **Environmental risk rating** – Banks are asked to report on environmental due diligence carried out in relation to loan applications from environmentally sensitive areas (agri-business, cement, chemicals, housing, engineering, metals, pulp and paper, tannery, sugar and distilleries, garment and textiles and ship-breaking). During FY2014 banks disbursed a total amount of 1,581 billion Taka (US$20 billion) to 30,540 rated projects (up from 270 billion Taka in 2011 and 703 billion Taka in 2012).[12]

- **Green finance** – Banks report on their exposure to 'direct green finance' which includes financing for key green technologies including renewable energy and biogas, water supply, wastewater treatment, solid and hazardous waste disposal, green buildings, green products and materials, clean transportation, land remediation, and sustainable land management. They also report on 'indirect green finance' which includes overall financing to projects with end-of-pipe effluent treatment. In 2014 indirect green finance totalled 354 billion Taka (US$4.5 billion) (up from 259 billion Taka in 2012), and direct green finance 44 billion Taka (US$0.5 billion) (up from 11 billion

Taka in 2012) as seen on Figure 4. The largest uses of direct green finance in 2014 were for brick kilns (4.9 billion Taka), and solar energy plant (2.3 billion Taka).

- **Green refinancing** - The green refinancing scheme is a 2 billion Taka (US$25 million) revolving loan fund. Overall 1,053.5 million Taka (US$13 million) have been disbursed from this fund during FY10-FY14.[13] The main uses were for biogas, solar assembly plant and energy efficient brick kilns (see Figure 5).

Figure: 4: Indirect and direct green finance disbursed in FY 2012 and FY2014

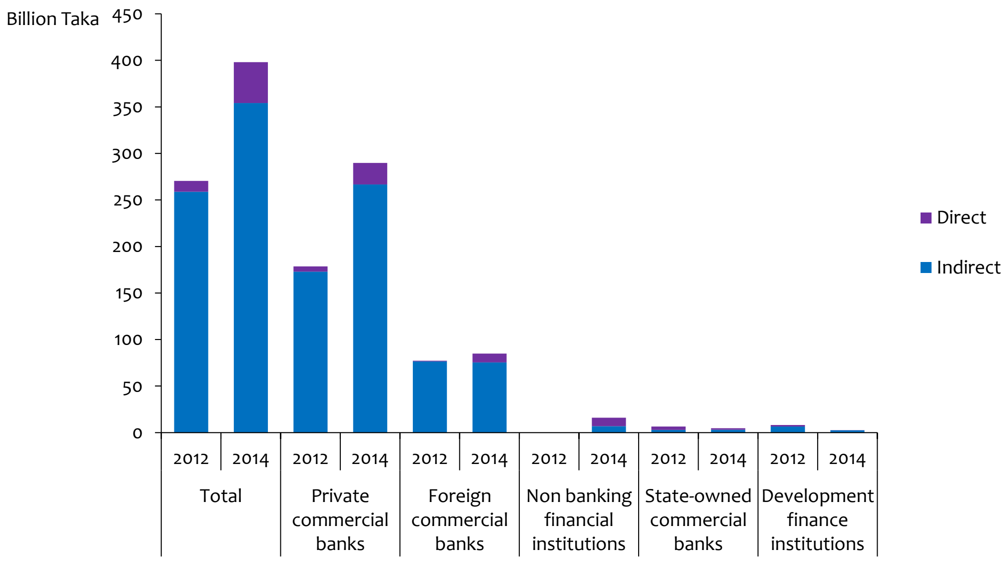
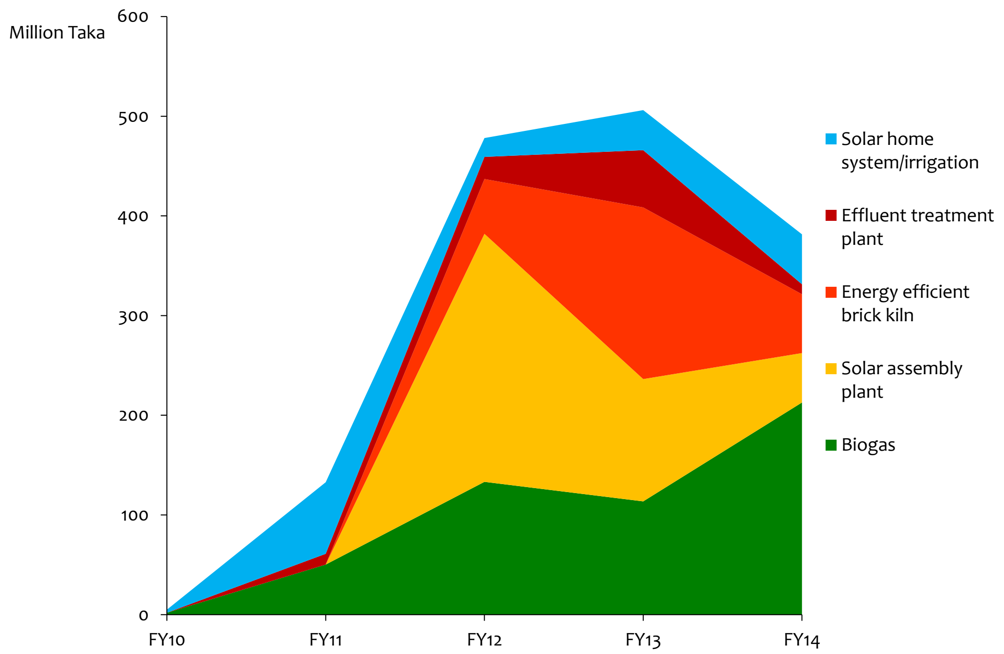


Figure 5: Use of green refinancing FY2010- 2014



3.2 Considering impact

It is clear that levels of green finance, and environmental risk-sensitized finance of every kind are rising, however the proportion of overall 'direct' green finance remains modest. Nevertheless impacts are already considerable. For example by December 2014 the programme for refinancing solar home systems had reached 15.5 million beneficiaries covering around 10% of the total population of Bangladesh.

The Bangladesh Bank stresses that it does not seek to force any institution to act against their will; it is rather trying to shift the drivers of motivation of the entire financial system so that there is a sound business case. The design of the program ranges from small amounts of public refinancing through larger volumes of specific commercial finance to shifts in overall behaviour of the sector. A key issue is the effectiveness and efficiency of the processes underlying the measured financial flows. For example, how robust are the environmental risk-rating processes (and are there learnings and best practices that can be scaled up)? Similarly, how effective is the refinancing instrument at supporting the development of new financial markets? In other words, does it operate simply as a subsidy managed by the financial institutions to make green solutions more affordable (and how well does it do this?) or can it enable banks to learn about new customers and markets, ultimately accelerating and enhancing the green character of their overall lending? Were the refinancing facilities to be phased out, would the banks' green lending continue, grow, or diminish?

The UNEP Inquiry proposes a diagnostic and performance framework for green finance which could be used to strengthen the ongoing monitoring of progress in shaping a green financial system, building on the initial quarterly monitoring and annual reporting framework which is already in place.

Box 4: UNEP Inquiry Performance Framework

Requirements: Capital required to deliver sustainable development

- What are the financial needs to deliver national priorities for sustainable development?
- What is the potential for public financing?

Flows: Flows of finance against such requirements

- What are current levels of finance set against needs?
- What are the resource and pollution intensive assets and investment?

Effectiveness: Degree to which the market prices sustainability factors are into asset values

- Where is the 'sustainability spread' greatest (e.g. the differential between market pricing of assets and full cost accounting of externalities)?
- How well are sustainability factors incorporated into financial decision-making?

Efficiency: Costs of running the financial system that delivers financial flows against requirements

- How cost-effective are different parts of the system in raising finance for sustainable development (e.g. IPOs, bond issuance)?
- How aligned are public incentives for financial activities with sustainable development (e.g. tax breaks for savings and investment)?[2]

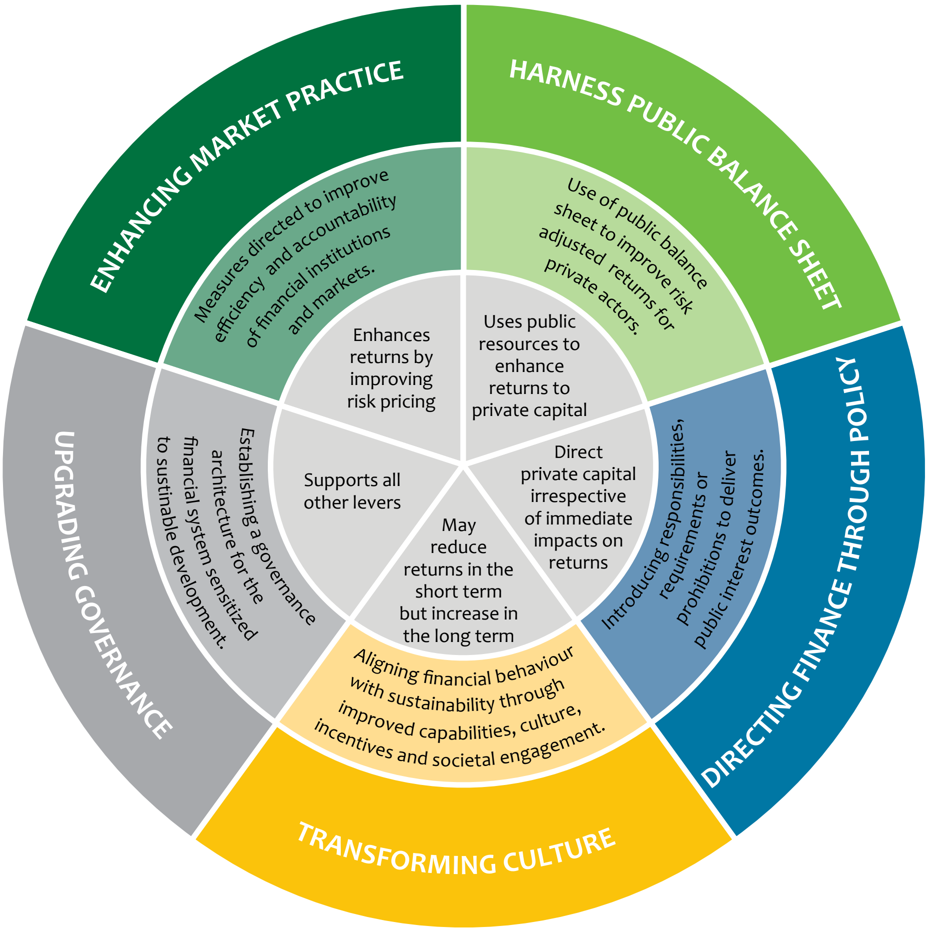
Resilience: Susceptibility of the system to disruptions related to unsustainable development

- What are the implications of environmental shocks on the financial system, now and in the future?
- What are the key sources of environmental stress that could result in asset stranding?

4 ADVANCING ACTION

The Inquiry's review of international experience highlights five distinct policy levers of change; all are important in the context of Bangladesh.[14] These have been developed into a general Framework for Action which can be applied flexibly.

FIGURE 5: THE INQUIRY'S FRAMEWORK FOR ACTION: FIVE LEVERS FOR CHANGE



Around the world these approaches are applied across the range of financial asset pools and actors, including banking, institutional investors, insurance, bond and capital markets. Bangladesh's current approach uses each of the five levers but is concentrated in the banking sector.

FIGURE 6: MAPPING BANGLADESH'S INITIAL STEPS

LEVER	ACTIONS IN RELATION TO THE BANKING SECTOR
Enhancing market practice	Environmental risk management and reporting guidelines
Harnessing public balance sheets	Green refinancing scheme
Directing finance through policy	Green credit quotas
Encouraging cultural change	Guidelines on greening banks' facilities and internal operations
Upgrading governance	Leadership led by the Bangladesh Bank, within its current mandate

This section sets out a range of ideas for further development of Bangladesh's green financial system across the full range of institutions and actors in the country, based on analysis by the IISD team in discussion with the Bangladesh Bank. It aims to provide the basis for developing a roadmap of innovations building on those already underway on a trial basis as well as promising new ideas.

In some cases mechanisms might be applied as a general measure (across all industries and issues), in other cases they may be targeted at particular areas such as the green transformation of agriculture, or the textile and garment industry.

4.1 Enhancing market practice

Measures to enhance market practice focus on improving the efficiency and accountability of financial markets and institutions, and in particular their effectiveness at assessing and pricing risks. Implementing such measures is a key opportunity both to shifting finance to green sectors and continuing to modernize the financial sector, making it more transparent and efficient.

An important next step would be to **review the practice and impact of the environmental risk management guidelines**. While data is collected about the number of banks undertaking environmental management, less is known about the impact of implementing the environmental risk management guidelines. Assessing this practice both through commissioning research and the development of learning networks of banks would help to identify best practice and build capacity. This could also link with international processes such as the Sustainable Banking Network. The Bangladesh Bank is already taking steps here to enhance this practice into Environmental and Social Risk Management.

A further capacity building next step, focused on banks and other financial institutions, would be to develop a protocol for financing key technologies and areas such as clean energy and energy efficiency. Such a financial protocol could provide market actors with a standardized approach to managing the performance risks and benefits associated with efficiency business transactions and renewable energy generation. This approach has been taken in Indonesia.

Other steps could go beyond the banking sector to build sustainability into broader efforts to grow the capital and bond markets:

- **Establish environmental information disclosure guidelines and requirements** for listed companies. At present, companies listed on the Dhaka stock exchange are required to provide an annual financial report. A first, immediate step could be to request all listed companies to include a chapter on their environmental footprint and on steps being taken to reduce it.

- **Develop new green equity and debt products and instruments.** Green bonds are being pursued in many countries as a means to raise long-term finance for green infrastructure. The development of markets for green bonds requires clear standards with a third-party assurance system for the green claims of corporate bonds issuers; for example, China's central bank is convening a national committee with the financial sector and industry to determine standards for green bonds.

- **Reduce transaction and registration costs for corporations seeking to do an IPO or debt issuance for a green project.** This is also a measure being taken in China. It requires agreement on clear standards of what might be considered a green project in the Bangladesh context.

- **Scale up insurance literacy programmes.** Insurance is an important financial product for enabling households to become financially resilient, including in relation to environmental risks. A fundamental starting point is to educate communities about the purpose of insurance, how it works, what it can and cannot do, and to help build trust. Without this fundamental understanding, it will be challenging to bring insurance products to scale and make them financially sustainable. This will take a long-term collaborative effort involving, among others, the ministry of finance, the insurance regulator, insurance associations, insurance companies, and civil society organizations.

A longer-term step as more companies, and bonds, become tradable as securities and are associated with environmental disclosures would be to **develop environmental indices** for equities and bonds to provide market players with financial benchmarks for green investments, bringing higher transparency to the market. This development might be reinforced with the use of public sector incentives through collaboration with established index providers and in cooperation with the Dhaka stock exchange.

4.2 Leveraging private capital with public finance

Bangladesh has made significant investments to leverage private investment through public finance from both the central bank and donors. Such resources need to be used carefully with the aim of catalysing wider changes rather than creating subsidized industries.

A critical next step is to **review and continue to develop the existing refinancing scheme**. The Bangladesh Bank has dedicated 2 billion Taka (US$25 million) to these schemes, which have now been in operation for six years. The time is ripe to undertake a first independent assessment of refinancing to understand its uptake and impact, to assess where amendments, course corrections or new approaches might be warranted. One step might be to allow qualified rural NGOs to handle refinancing loans in order to make the green loans more accessible to the final users.

Another catalytic step, which could be boosted with public finance, is to **encourage commercial banks to create long-term deposit accounts and other savings products**. Long-term deposit accounts would prevent commercial banks from incurring asset liability mismatches and would allow them to offer longer-term loans for green infrastructure and renewable energy projects. To attract savers, these long-term deposit rates could be supported by tax exemption on interest earnings, for example through pension and retirement savings schemes supervised by a pension fund regulatory authority set up by the government. The Bangladesh Bank has, for some years now, been in discussion with the government to take action on this crucial market development priority.

Public finance might also be used to **provide credit enhancement for green projects and green securitization** in order to kick-start the development of a green bond market. A certain minimum deal size is required for bond issuance. To tap mainstream bond markets for green finance, mechanisms might be put in place that allow smaller loans and assets to be 'bundled' and appropriately packaged. Asset-backed securitization issuance, offered by the public sector to bonds meeting specific criteria, might be developed to address this need. This is an area where international development banks have considerable experience.

Leveraging public backing for green insurance to de-risk low-carbon solutions and achieve more green, bankable projects. Aside from financial risk protection, green insurance solutions can support the transition to a low-carbon economy. Fiscal incentives could be explored for green insurance in order to allow investors to de-risk green projects, thus attracting effective private investment into the low-carbon economy by achieving better risk-adjusted returns on green solutions. Insurance presents a feasible solution to achieve more green, bankable projects with innovative products such as energy efficiency or savings insurance, pay-as-you-drive, renewable generation insurance, geothermal exploration insurance, etc.

4.3 Directing finance through policy

Greening finance does not call for rolling back Bangladesh's market-based financial reforms, but it does suggest that directing finance where it is used should be aligned to national environmental priorities. Furthermore such mechanisms can offer a targeted means for overcoming barriers to finance for green investment.

There is potential for **greening the Bangladesh Small and Medium Enterprise (SME) Credit Policies and Programmes** by developing lending policies to give additional preference to SMEs implementing green investments and integrating this into existing policies and incentives.

Another key area to consider is **establishing specific targets for key areas of green investment**. The Bangladesh Bank has set a minimum 5% target for green finance as a proportion of the total loan portfolio. However, many financial institutions can already meet this target with 'indirect green lending' to conventional industries with end-of-pipe effluent treatment. The overall target might be strengthened with specific targets in key areas such as solar energy and energy efficiency loans – to support scaling up the already impressive deployment of solar home units, solar irrigation pumps, and other solar PV technology, and to accelerate the sluggish market uptake of energy efficiency lending.

4.4 Encouraging cultural transformation

The Bangladesh Bank has taken several steps to raise awareness and promote cultural change towards understanding of environmental risks and opportunities, particularly in the banking sector. The Green Banking Policy Guidelines did not only require changes to bank credit policies, but the development of internal policies, governance and reporting. The developing environmental awareness in the banking sector could form the foundations for a **forum for engagement and networks for learning** both with industrial and commercial leaders, and with other parts of the financial sector.

Another key step would be to **explore the linkages between Islamic banking and sustainable development**. Islamic banking principles based on risk sharing and mutual aid are in many ways favourable to the aims of sustainable development; it would be important to seek a convergent path between Islamic banking and insurance and the needs of Bangladesh's green transformation.

A further step might include **promoting international green investors' initiatives and establishing a green investor's network locally**. The Dhaka stock exchange is not only interested but committed to creating space for a thriving green securities market under its auspices; it is presently reviewing the rules governing the stock exchange to create the necessary space and put in place the mechanisms to ensure its smooth functioning. It could leverage international best practice by signing up to the Sustainable Stock Exchange initiative based at UNCTAD in Geneva and participating in its activities.

Box 5: Islamic Finance

Banking based on Islamic principles accounts for 20% of all deposits and 23% of all credit in Bangladesh. The Bangladesh Bank included sharia-compliant funds within its green refinancing scheme.

The fundamental objectives of Islamic banking – and especially the adherence to fair, equitable and socially responsible principles – would appear to offer privileged alignment with the principles of sustainable development. In particular there is the *gharar* principle, which translates into a ban on speculation. Consequently, investors are required to execute transactions with the sole interest of the instruments' underlying value, thus strengthening the link between the investment and development in the real economy. Despite this in principle coherence, to date, the experience is inconclusive. For example, it is as yet unclear whether the Islamic principles for banking genuinely help to align the financial markets with green and inclusive development.

4.5 Upgrading governance architecture

Leadership on green finance remains concentrated with the Bangladesh Bank. While its leading role is likely to continue, steps could be taken to integrate green finance more fully into the governance of Bangladesh's financial system.

Implementing these in the next few years would both enable the creation of new financial market instruments and build a growing constituency for green finance in Bangladesh. This would kick-start a movement that could take green approaches to finance into the mainstream and help realize their considerable potential to contribute to sustainable development in the country.

The Bangladesh Bank has made the case for supporting green and inclusive investment as a critical contributor to monetary stability.[15] A further step would be to **explore how best to align monetary targets with sustainability objectives**. The Bangladesh Bank's monetary targets are focused on inflation as well as money and credit growth. However, the case has been made that enabling green and inclusive economic growth is a vital contributor to financial stability in Bangladesh.[16] A process should be initiated to review and identify how sustainability might become an explicit component of the Bangladesh Bank's target-setting process.

A specific green finance chapter could be introduced to **the 7th five-year Plan**. The General Economics Division (GED) of the Planning Commission is in the process of preparing the 7th five-year Plan (2015-16 to 2019-20). Green targets have been included in the plan but a framework on how to achieve them or how the targets could potentially be financed is missing. GED welcomes a specific contribution on green finance that would, once adopted, constitute formal government-wide policy on green finance. The goals and objectives contained in such a contribution should be matched with an action plan with specific green targets and an allocation of responsibility for their attainment.

An increasing number of countries, including China, Indonesia and South Africa are developing national **Green Finance Committees**. Starting from the initial foundations already in place around green banking, a strategic platform could be developed for finance sector stakeholders to consider opportunities and issues and build consensus for innovation and reform. This might be convened by the Bangladesh Bank and served by its Sustainable Finance Department, and could involve representatives from relevant government departments, state-owned financial bodies, regulators, research and academic centres, civil society and the private sector.

Broadly speaking, the reforms proposed for the banking sector might be implemented most rapidly. Many are indeed already underway and require diligent implementation, assessment and scaling up. However, those that address other parts of financial and capital market, such as debt finance markets, insurance, equities and institutional investors, will need to be developed alongside, and as an inherent part of the institutions, rules and regulations, standards, data systems, skill-building and market education needed for the development of Bangladesh's financial and capital markets.

4.6 Towards a Green and Inclusive Financial System

This brief, and the technical report on which it is based, underlines three things. First, the leadership of the Bangladesh Bank has played a critical role in initiating steps to both the greening of the nation's financial sector and the progress of financial inclusion. A national debate on the importance of aligning the financial sector with the broader objective of sustainable development has started, and initial instruments have been developed, and a new wave of creative innovation unleashed.

Second, there are opportunities to go further and accelerate progress to generate a vibrant green finance sector in Bangladesh. These ideas could be developed into a roadmap with leadership and involvement

Figure 7: Summary of policy options

	Banking	Institutional investment	Insurance	Bond markets	Capital markets
Enhancing market practice	Reviewing environmental risk management guidelines implementation	Create environmental indices	Consumer education on insurance	Developing new green products and standards	Environmental disclosure requirements
	Develop green investment assessment protocols				
Harnessing public balance sheets	Review existing refinancing scheme Financial incentives for long term savings products		Public support on green insurance	Credit enhancement for green project bonds	
Directing finance through policy	Greening the SME priority lending programme Establishing specific targets for key areas of green investment				
Encouraging cultural change	Building green banking and business network Exploring Islamic finance and sustainability	Developing green investors network			
Upgrading governance	Developing a green finance chapter in the 7th five-year Plan Creating a Green Finance Committee Exploring how to align monetary targets with sustainability				

not only of the Bangladesh Bank but also involving other financial regulators, financial institutions, the microcredit industry, civil society, stock exchanges, credit ratings and private standard setters. It represents a bold, exciting and practical agenda.

Thirdly this would not be a lone journey but one that is also being undertaken by other developing and developed countries, in many cases developing standards, protocols and networks for sharing best practice and lessons.

ENDNOTES

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Inquiry: Design of a Sustainable Financial System

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