

# Aligning Colombia's Financial System with Sustainable Development



## Authored by

Juan Manuel Ramírez, Gabriel Andrade Bravo and Juan Luis Botero, conTREEbute

Carlos Flórez, Independent Financial Expert

Camilo Botero, Veronorte

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# Aligning Colombia's Financial System with Sustainable Development

A range of factors is driving increasing focus within the financial system on the linkages with sustainable development. With a new set of Sustainable Development Goals from the United Nations (UN) to be agreed upon in September 2015 and the Climate Change Conference of the United Nations Framework Convention on Climate Change (UNFCCC) coming up in Paris at the end of 2015, national and international organizations are interested in providing enabling conditions for a greener economy.

In this scenario, the financial system plays a fundamental role in mobilizing capital to a greener economy and creating general awareness about the importance of this shift and the opportunities it creates. Domestic policies and frameworks play a critical role, and almost three-quarters of climate finance, one of the components of sustainable finance, originates and is being invested in the same country.<sup>1</sup>

Sustainable or green finance, terms that will be used interchangeably in this document, refers to the capability of the financial system to integrate environmental, social, and governance (ESG) criteria in the investment or credit decision-making process, and to allocate resources in projects, financial assets, or portfolios with a positive impact on sustainable development challenges.

Since 2012, the G20 Development Working Group has been focusing on inclusive green growth and has asked the International Finance Corporation (IFC) to support its efforts to mobilize private investment, including from institutional investors, in this regard. Supported by Germany's *Gesellschaft für Internationale Zusammenarbeit* (GIZ), IFC is working with the G20's GreenInvest Platform to create the enabling environment and engage domestic investors in countries to support this agenda. The United Nations Environment Programme (UNEP) recently initiated the "Inquiry into the Design of a Sustainable Financial System" (UNEP Inquiry) to advance design options that would deliver a step change in the financial system's effectiveness in mobilizing capital toward a green and inclusive economy. Working in partnership, IFC and UNEP are exploring this topic in Colombia.

This document has been commissioned by the IFC and the UNEP Inquiry to explore the state of green finance in Colombia within the wider economic and financial sector context, and at the same time, to identify challenges and potential solutions that would enhance the application of environmental, social, and governance (ESG) criteria in the financial sector decision-making process and mobilize more investments for the transition toward a green economy.

The project involved two major steps: first, it undertook a holistic mapping of the Colombia green finance landscape with regard to the relevant stakeholders and the relevant types and volumes of finance, as well as current and planned financial policies, regulations, and standards; second, it then identified the challenges that prevent increased green capital flow, and discussed how these might be overcome.

The consulting team conducted more than 32 interviews with the heads of relevant institutions in the financial sector - specifically, private pension funds, private equity funds, insurance companies, commercial banks, development banks, asset managers, financial associations, government and regulatory agencies, and private standard setters, underpinned by desktop research based on public information sources.



## ECONOMIC AND ENVIRONMENTAL CONTEXT

Colombia is one of the most dynamic emerging economies and has consistently improved its economic development indicators. In fact, GDP has grown at average rates of 4.7 percent (2003-2013), the inflation rate has dropped below 4 percent for the last five years, and foreign direct investment has multiplied by 10 in the last 10 years. However, in 2013, the oil and gas industry represented nearly 50 percent of exports, 16 percent of fiscal income, and 5 percent of GDP, which shows the importance of this carbon-intensive sector for the economy. Moreover, Colombia ranks as the 51<sup>st</sup> country in terms of the highest greenhouse gas (GHG) emissions per capita. In addition, the country is vulnerable to extreme weather events: over the past 40 years, natural disasters in Colombia have caused \$7.1 billion<sup>2</sup> in losses, with severe floods in 2011 causing an estimated of \$4.9 million<sup>3</sup> in damage.

## GREEN GROWTH POLICIES IN COLOMBIA

The Colombian Government has implemented three kinds of long-term development policies for green growth: strategic policies, operational policies, and specific incentives.

The strategic policies include the OECD Declaration on Green Growth and the National Development Plan 2014-2018 (in process of approval by the Congress) that defines a crosscutting strategy of Green Growth. The operational policies include the “Institutional Strategy for the Articulation of Policies and Actions Related to Climate Change” (CONPES 3700) that creates the National System for Climate Change (SISCLIMA) and the SISCLIMA Financial Committee. This category also comprises the Intended National Determined Contributions (INDC) and the National Green Business Plan at the Ministry of Environment. Finally, the government has developed specific incentives for green investments, such as economic incentives, tax-related incentives, and research and development (R&D) incentives.

Based on this policy framework, it is possible to determine a general estimate of the challenge that the Colombian economy faces in order to make the transition toward a greener economy. The National Development Plan 2014-2018 baseline document indicates total financing needs from the Green Growth crosscutting strategy of \$3.8 billion, mainly from public sources. Moreover, CONPES 3700 (Climate Change Strategy) also outlines general estimates for climate change adaptation and mitigation financing needs, using some of the main strategic projects at the country level. According to this estimate, the climate change component alone will require around \$3.2 billion, primarily from public sources; the full amount including private sources would be much larger.

## GREEN FINANCE EXPERIENCE IN COLOMBIA

The Colombian financial system has reached a relevant size within the economy while enjoying a healthy position, characterized by controlled non-performing loan rates properly provisioned, solvency ratios above minimum requirements, and solid profitability measures.

Moreover, the financial system has made sound advances in the integration of ESG criteria into the decision-making process. The governance criterion has the longest trajectory of implementation, followed more recently by the environmental factor. The “Código País” experience related to governance criteria is an interesting example of how a new topic can be integrated into the financial sector agenda, creating general awareness, and becoming a useful tool to strengthen risk analysis. However, new and

emerging sustainability risks (different than transparency, corruption, and governance structure risks) such as stranded assets risk, climate risks, and social risks, among others, have not been fully integrated into the financial institutions' risk assessment.

Commercial and development banks present the most relevant advances in green finance among the financial subsectors. However, there is still a gap in integrating green finance into the banks' core business. Banks are using relevant frameworks for integrating sustainability criteria into their decision-making process (e.g., The Equator Principles, Principles for Responsible Investment – PRI, Natural Capital Declaration) and have engaged in relevant sustainability initiatives such as the Dow Jones Sustainability Index (DJSI), United Nations Global Compact, and Global Reporting Initiative (GRI), among others. In 2012, some of the most relevant commercial and development banks associated in ASOBANCARIA signed the Green Protocol, a commitment to promote green finance. Commercial banks and development banks have also started to evaluate the implementation of environmental and social management systems (SARAS for its acronym in Spanish). However, only 6 out of 17 banks have established between one and four products under a “green” denomination, and green credit lines comprise only between 0.1 percent and 2.43 percent (an estimated \$164 million) of the total banks' portfolio.

The Colombian Stock Exchange (BVC) has been a relevant actor promoting green finance. In 2011, the Securities Exchange adhered to the United Nations Global Compact and defined a sustainability strategy. In July 2014, it partnered with the United Nations Sustainable Stock Exchanges (SSE) and committed to increase awareness of responsible investment in the Colombian market, disseminate its Guides to Responsible Investment, and support the development of the Colombian chapter of the Latin Forum of Sustainable & Responsible Investment (Latin SIF).

Institutional investors such as pension funds and insurance companies are starting to identify opportunities to integrate green finance elements in their businesses, but still lack robust initiatives and general awareness inside their organizations.

Private equities, led by Colcapital, have some relevant initiatives aimed at recognizing the social and environmental performance of their investments. However, this is still not a generalized practice. On the other hand, there are already some private equity funds fully dedicated to impact investing and identifying ESG factors as business opportunities.

Market analysts and credit rating agencies have started to develop frameworks and tools to assess ESG risk factors in their analysis. However, those frameworks are not as sophisticated and developed as operational and financial risk frameworks.

## CHALLENGES AND PROPOSED SOLUTIONS

Based on this experience and the interviews conducted, this report highlights the main challenges and potential solutions that were raised from the interviewees' perceptions and opinions. This process is intended to contribute to an applied, down-to-earth approach to understand the green finance landscape in Colombia and identify practical recommendations.

Based on the analytical framework proposed by the OECD, there are three main categories of green finance challenges and potential solutions:<sup>4</sup>

Challenges or solutions	Definition
<b>General</b>	These are challenges or potential solutions that relate to the general Colombian investment and financial ecosystem, and that have effects on investing in any kind of company, project, or financial instrument, or applying any kind of evaluation methodology.
<b>Specific to green finance</b>	These are challenges or potential solutions that relate specifically to the green finance ecosystem in the country, and that have a direct effect on green investments, whether projects, companies, or financial instruments.
<b>Related to environmental, social and governance (ESG) methodologies</b>	These are challenges or potential solutions that relate specifically to the green finance ecosystem in the country, and that have a direct effect on integrating environmental, social, and governance (ESG) criteria into the investment or financing decision.

The next table presents the challenges and proposed solutions identified during the interview process for Colombia:

Category	Challenges	Proposed solutions
<b>General</b>	<ul style="list-style-type: none"> <li>• Short-term prevalence in the decision-making process.</li> <li>• Low market capitalization.</li> </ul>	<ul style="list-style-type: none"> <li>• Strengthen corporate governance and long-term vision in financial institutions.</li> <li>• Promote transformational leadership.</li> </ul>
<b>Specific to green finance</b>	<ul style="list-style-type: none"> <li>• Lack of standard definitions around green finance.</li> <li>• Lack of clarity around environmental impacts (positive or negative).</li> <li>• Absence of green investments pipeline.</li> <li>• Gaps in innovative initiatives.</li> </ul>	<ul style="list-style-type: none"> <li>• Establish basic standard definitions for green finance.</li> <li>• Develop incentives for financial institutions that promote green finance.</li> <li>• Have government be a sponsor of green investments, specifically projects.</li> <li>• Articulate information sources and entities around green finance.</li> <li>• Design and promote attractive market signals (certifications, seals, etc.)</li> <li>• Strengthen financial institutions' disclosure of their green finance performance.</li> <li>• Focus capital market innovation in collective investment funds, private equity, ETFs, and green bonds.</li> </ul>
<b>Related to environmental, social and governance (ESG) methodologies</b>	<ul style="list-style-type: none"> <li>• Lack of standardized methodologies.</li> <li>• Lack of specific capabilities for assessing ESG factors.</li> </ul>	<ul style="list-style-type: none"> <li>• Implement standardized methodologies and tools for risk assessment.</li> <li>• Provide permanent education and communication for practitioners.</li> <li>• Create specialized teams, with specific ESG capabilities.</li> </ul>

# RECOMMENDATIONS AND NEXT STEPS

Evidence in other countries has shown some levers that can lead to a significant transformation in the financial system toward green finance. In Colombia, there are four main levers that can lead to sound transformations in the financial system:

- **Exemplary leadership:** individual institutions such as Grupo Sura, Grupo Bancolombia, and Davivienda, the Colombian Stock Exchange, or responsible investment funds such as Fondo Inversor, can show the benefits of green finance and the competitive advantage it creates, and can transfer best practices to other market players.
- **Real sector crisis:** crises are always a powerful driver for change. Major natural disasters or major industrial disasters, originated in environmental or social issues, can focus the attention of investors and civil society, and can lead to a general awareness of green finance. The La Niña phenomenon in 2010-2011 is an example of this.
- **Policy innovation:** there are interesting experiences such as Código País related to governance criteria integration, the micro-finance industry development in Colombia, the financial committee at SISCLIMA, and the active participation of government institutions in Green Protocol. Replicating these practices to other financial subsectors and articulating them into a generalized, country-level green finance vision can become a significant lever for change.
- **Multilateral institutions requirements:** great-scale infrastructure projects will become part of the Colombian economy landscape in forthcoming years. Those projects demand significant resources, most of them provided by multilateral institutions. These institutions demand rigorous approaches to social and environmental risks that can spill over to the financial institutions and, finally to the real sector.

Regulations around green finance may be proposed in order to create mechanisms to increase the viability of projects or investments with positive impact on sustainable development challenges, as well as restrictions for projects or activities that have a negative impact on the environment. However, in the context of Colombia, there is a need for a debate about what kind of intervention is needed in order to mobilize green finance and the role for all the stakeholders in this process.

Finally, taking into account that there are several ongoing initiatives from the financial sector that are showing good practices for the entire financial system, especially in commercial and development banks, there is an opportunity to find potential paths to mobilize other institutions. In particular, this opportunity reflects the potential to better manage long-term sustainability risks, mobilizing capital at the necessary scale based mainly on the fourth generation (4G) infrastructure plans, and strengthening the market infrastructure with standards and methodologies for ESG risk assessment, disclosure, and transparency, among others, which could enable the transition toward a greener, more inclusive economy.

## ENDNOTES

- 1 *References an analysis in the Global Landscape of Climate Finance 2014 produced by the Climate Policy Initiative.*
- 2 *World Bank and Global Facility for Disaster Reduction and Recovery “Análisis de la gestión del riesgo de desastres en Colombia”: 2012.*
- 3 *Bases del Plan Nacional de Desarrollo 2014-2018. Capítulo “Crecimiento Verde”.*
- 4 *Kaminker, C. et al. (2013), “Institutional Investors and Green Infrastructure Investments: Selected Case Studies”*





## Aligning Colombia's Financial System with Sustainable Development



**Inquiry:** Design of a Sustainable Financial System



**IFC**

**International  
Finance Corporation**  
WORLD BANK GROUP

**Inquiry:** Design of a Sustainable Financial System

International Finance Corporation

International Environment House  
Chemin des Anémones 11-13  
Geneva,  
Switzerland

2121 Pennsylvania Avenue, NW  
Washington, DC  
20433 USA

Tel.: +41 (0) 229178995  
Email: [inquiry@unep.org](mailto:inquiry@unep.org) - Twitter: @FinInquiry  
Website: [www.unep.org/inquiry/](http://www.unep.org/inquiry/)

Tel: (202) 473-3800  
Fax: (202) 974-4384

Website: <http://www.ifc.org/>