

## **RESEARCH CONVENING ON DESIGN OPTIONS FOR A SUSTAINABLE FINANCIAL SYSTEM**

**CENTRE FOR INTERNATIONAL GOVERNANCE INNOVATION (GIGI)**

**THE UNEP INQUIRY INTO THE DESIGN OF A SUSTAINABLE FINANCIAL SYSTEM**

The Centre for International Governance Innovation (CIGI) and the UNEP Inquiry into the Design of a Sustainable Financial System are to hold a two-day convening of key academics and experts, starting on the evening of the 1<sup>st</sup> December and ending early afternoon of the 3<sup>rd</sup> December 2014, at CIGI's headquarters in Waterloo, Ontario, Canada.

### **Background**

In context, the Convening is aimed at identifying and appraising policy options that would increase the financial system's capacity to channel resources towards a sustainable and green economy. In a nutshell, the context is one where there is widespread concern that the financial system is not fit for its public purpose of meeting the needs of the long-term health of the real economy.

The Convening is intended to address key pertinent theoretical and empirical questions that support the broader applied, policy research agenda concerning the contours of a sustainable financial system. In addressing these questions, the Convening seeks to establish the basis for a research agenda going forward, some of which can be taken up by the hosts - by informing their respective research agendas - and by the participants, but more importantly can inform the work of many researchers and research institutes, and also the framing of research financing.

### **The Convening**

The Convening will comprise 15 leading researchers from the fields of financial systems and sustainable development, drawn internationally to ensure a broad representation of issues and perspectives.

- Each researcher will offer a substantive theoretical and/or empirical paper for the Convening that will address one or more of the core research questions set out below.
- Each paper will be to publishable quality in a mid to upper-rated, peer-reviewed journal and will either not have been published or submitted for publication, or else will be available for re-publication by the co-hosts.

Based on the Convening, a number of papers presented will be selected for inclusion in a jointly-branded publication by the co-hosts. In addition, further papers may be published separately as jointly or single host branded working papers, together with the authoring institutions as appropriate.

## Research questions

The Convening is designed to address a number of core questions defined by the co-hosts as being key to furthering our understanding of the features and potential pathways towards a sustainable financial system:

### The case for financial system intervention

1. What are the relative merits of deploying financial over “real economy” policies and regulations to address environmental and equity issues and outcomes?
2. How does financial market structure, including levels of concentration and ownership, impact social and environmental outcomes?

### System horizons: understanding the dynamics of time and risk

3. What is the relationship between long-term investment horizons and sustainability outcomes, and what factors determine these time horizons?
4. What is the impact of short-term trading activity and intra-sector trading on environmental and equity outcomes?

### System Governance: principles, mandates and purpose

5. Should, can and do international finance governance institutions and processes take social and environmental issues into account?
6. How does, can or should analysis of systemic risk under macro-prudential activities take social and environmental matters into account?
7. Do different configurations of financial policy and regulatory authorities impact their capacity to address social and environmental objectives?
8. What is the case for (and against) and practice of central banks and financial regulators directly and indirectly pursuing social and environmental objectives?
9. What is the impact of differing forms of, and policy approaches to credit creation on social and environmental outcomes?

### Responsibilities, incentives, information: steering financial institutions

10. How do fiscal support and incentives directed at the financial sector & beneficiaries of financial products impact on environmental and equity outcomes?
11. How does, can or should investor governance and associated public policies take social and environmental matters into account?
12. What is case for (and against) and practice of different approaches to policy-incentivized lending in addressing social and environmental objectives?

### Tomorrow’s financial system and change pathways

13. How might and could technology and institutional innovations in the financial sector impact social and environmental outcomes?
14. How best can financial policy and regulation aimed at social and environmental outcomes be sequenced and how can trade-offs be understood?
15. What is the role of citizens as consumers, investors, employees and/or as social movements in effecting the financial system’s impact?

These questions are of course not exhaustive and the co-hosts will consider proposals to address other questions relevant by virtue of their exploration of:

- Specific theoretical aspects.
- Previously under used data sets with relevant applications.

For each paper, the following four components would be expected to be covered:

- Theoretical aspects
- Empirical application and analysis
- Implications for policy and practice
- Research needs going forward.

In general, papers will not be considered that offer a:

- Broadly discursive approach.
- A narrative case study, or collection of case studies without a core theoretical and empirical methodology for analysis.

### Timeline

The key dates of the Convening and associated activities are as follows:

- August (2014): Submission of short abstracts.
- Early September: Notification of authors and invitation to submit draft paper.
- Mid-October: Initial drafts of papers to be submitted, possible de-selections.
- Mid-November: Papers submitted and circulated to all participants.
- December 1<sup>st</sup> – 3<sup>rd</sup>: Research Convening held in Waterloo, Ontario, Canada.
- End-December: Selection of papers for publications.
- End-February (2015): Final papers submitted for publications.
- June: Publications.

Selections and editorial will be undertaken jointly by CIGI and the Inquiry. In case of any questions, please contact Andrea Liesen (UNEP Inquiry) at [aliesen.unep@gmail.com](mailto:aliesen.unep@gmail.com).

Please submit a short abstract of your paper no later than August 31<sup>st</sup> 2014 including:

- Title of your contribution
- Authors, affiliations and contact information
- Details on which of the above questions you will address (or which other ones you propose to address)
- A short summary of approximately 150 words outlining the theoretical framework, analytic methodology and policy/practice significance of your contribution.

Please send your short abstract to [aliesen.unep@gmail.com](mailto:aliesen.unep@gmail.com).

## Annex 1: Research Questions - Background Briefing

This annex draws on the Inquiry's initial white paper, published in June 2014: **Aligning the Financial System with Sustainable Development** and sets out the context for the research questions.

### Definitions and scope of the Inquiry

The Inquiry has taken as a starting point the International Monetary Fund's description of the **financial system** as including: *"banks, securities markets, pension and mutual funds, insurers, market infrastructures, central bank, as well as regulatory and supervisory authorities"*. This definition makes clear that the financial system is more than the sum of its market actors, and includes the institutions specialised in making and overseeing the rules governing the system at national and international levels.

A **sustainable financial system** is one that shapes a real economy that can operate safely over time within local and planetary boundaries and deliver improved financial inclusion and social equity.

The Inquiry is focused specifically on design options for the **'financial rules of the game'**; incorporating a suite of tools that can be deployed to promote the public interest to ensure the accountability of the financial system to its beneficiaries and those impacted by its operations. In its focus on delivering a sustainable financial system, the Inquiry is focusing on six broad categories of financial policy innovation:

1. **Financial policy**, mainly set by Ministries of Finance or equivalent.
2. **Financial regulation**, deployed mainly by financial regulators and supervisory bodies.
3. **Monetary policy** by Central Banks to manage credit creation and price stability.
4. **Fiscal policy**, which influences financial market behaviour, such as subsidies for savings and investment.
5. **Private standards**, including accounting and reporting, stock exchange listing requirements, credit ratings, and industry accords.
6. **Policy-directed financial institutions**, such as Sovereign wealth Funds and development banks, including the new generation of 'green investment banks'.

### The case for financial system action

Governments, acting in the wider public interest, have historically intervened in the financial system. However not every green economy problem or opportunity where finance is involved, can or should be addressed through interventions in the financial system. 'Real economy policies' such as more stringent and effectively enforced building standards and eradicating perverse fossil fuel subsidises, are both critical steps to channel capital into low-carbon assets. But these may not be sufficient alone.

**The Inquiry identifies main circumstances that may justify interventions in the financial system to complement classic policy:**

1. **Resolving Systematic Biases in Risk Assessment:** market imperfections and inefficiencies through asymmetric information, misaligned incentives, short-termism and insufficient responsibilities can create systematic biases that result in the under-estimation of environmental and social risks. These market failures in the financial system itself may lead to investors and financial intermediaries not responding as expected to regulatory and price signals.<sup>i</sup> Furthermore this can compound the barriers to capital reallocation that flow from market

failures in the real economy (such as mispricing for natural capital assets such as carbon, soil and water). The result is a misallocation of capital, including over-investment in unsustainable assets that could be at risk from unexpected downward adjustment in asset values, the stranded asset argument<sup>ii</sup>. A failure to address the root causes of these financial inefficiencies can also result in disorderly markets, characterized by instability and rising litigation.

2. **Achieving policy coherence to remove unintended effects of regulation:** failing to consider long-term environmental and social factors in policy design can and does lead financial regulation to have unintended negative consequences for the allocation of capital to the green economy<sup>iii</sup>. For example, there has been widespread concern, particularly in Europe, that Basel III and Solvency II have unintentionally dampened investor enthusiasm for long-term infrastructure financing, including renewables<sup>iv</sup>. Under current prudential rules green and low carbon investment strategies are often evaluated as carrying higher risks and lower returns in the short-term and therefore incur higher costs for institutions than resource-intensive strategies<sup>v</sup>.
3. **Harnessing financial policy opportunities to realise green and inclusive outcomes in the real economy:** Policymakers may be missing opportunities for ‘win-win’ measures that deliver positive financial and environmental outcomes in the real economy. Green financial policies can help to complement traditional environmental policies to reduce pollution, for example, through green credit guidelines. Equally, the incorporation of environmental factors can help to strengthen traditional approaches to financial analysis, for example, by integrating energy costs into loan appraisal; this could equally be applied at the system level. In reality, given that traditional policy approaches to the green economy are unlikely to be sufficient to achieve the desired goals, exploring options in the financial domain makes sense particularly where there is policy delay and/or weaknesses in effective execution. The financial system can potentially deliver a particular form of ‘market discipline’ to drive the green economy as part of a wider agenda.

Research questions	Implications for policy and practice
<ol style="list-style-type: none"> <li>1. <b>What are the relative merits of deploying financial over “real economy” policies and regulations to address environmental and equity issues and outcomes?</b></li> <li>2. <b>How does financial market structure, including levels of concentration and ownership, impact environmental and social outcomes?</b></li> </ol>	<p>What are the areas where financial system intervention is most critical and/or most likely to be effective?</p>

### System horizons: understanding the dynamics of time and risk

Long-term investment horizons and sustainability are clearly closely related, but are not the same. Furthermore there is inadequate understanding on how short termism impacts upon the alignment of the financial system to a green and inclusive economy.

Aligning the financial system with the transition to a green economy will require a much deeper understanding of the ways in which time horizons influence the allocation of capital.

Discounting future value is a classic feature of financial decision-making, but one that can exclude long-term resilience as well as environmental and social factors that are not captured in prices. This is then exacerbated through “the plague of short-termism” to use the phrase of Dominic Barton and Mark Wiseman, which deters productive investment in the real economy and slows the transition to a sustainable economy<sup>vi</sup>. Recent policy debate has highlighted the dampening effects of short-termism on long-term investment, for example, through the Kay Inquiry in relation to equity markets in the UK.<sup>vii</sup> Alongside this has been a growing policy priority placed on mobilizing vital long-term investment in the wake of the financial crisis. For the G30 group of economic experts, one key is to ensure that policymakers understand “the systemic impact of ongoing and future regulatory changes on long-term investment”.<sup>viii</sup> Under the aegis of the G-20, considerable work has been undertaken to put in place practical policies to finance the global infrastructure gap. One result has been the joint G-20/OECD set of high-level principles to assist countries to promote long-term investment by institutional investors. This highlighted the need to address the challenge of climate change and other pressures on the environment via long-term investments in renewable energy and low-carbon technologies.<sup>ix</sup> Labour unions have also called for a new investment framework to “secure investment of workers’ capital in long-term investments in the real economy and increasingly in green technology, infrastructure and services”<sup>x</sup>. As yet, however, the potential synergies between the three agendas of reducing short-termism, mobilising long-term capital and harnessing this for the green economy has not been realised.

The scope of financial risk management will also need to be rethought to establish how the transition to the green economy impinges on existing risks to credit, markets and systems, as well as how notions of materiality may need to be updated. The key here is how long-term environmental and social risks can be brought forward into today’s decision-making to enable market participants to act with foresight to minimise the financial disruption to existing ‘sunk’ assets and prevent the further misallocation of capital.

Research questions	Implications for policy and practice
<p>3. <b>What is the relationship between long-term investment horizons and sustainability outcomes, and what factors determine these time horizons?</b></p> <p>4. <b>What is the impact of short-term trading activity and intra-sector trading on environmental and equity outcomes?</b></p>	<p>What steps are needed to fully integrate the sustainability dimension into the long-term investment agenda? What are the policy and regulatory levers that can effectively reconcile the short- and long-term dynamics of the financial system with a green and inclusive economy?</p>

## System Governance: principles, mandates and purpose

There is consensus that the purpose of the financial system is to serve the real economy – and for the Inquiry this is interpreted in terms of the necessary transition to a green and inclusive economy. This means that the Inquiry needs to understand the implications for the national and international policy architecture that governs the financial system. This involves a number of components, notably principles, coordination and mandates.

At the international level, the financial system is guided by a host of ‘soft law’ agreements, standards and principles, which are then implemented at the national level and monitored through a variety of international mechanisms<sup>xi</sup>. These include the Basel accords rules on banking, the FSB’s principles for effective risk appetite, the IAIS’s Insurance Core Principles, IOSCO’s objectives and principles of securities regulation, and IOPS’s principles of private pension provision. More recently, additional sets of principles have been established around long-term finance. Key aspects of these rules are highly relevant for the green economy. As yet, however, there is no specific set of principles guiding policy makers concerned with financial markets and sustainability. In parallel, there are a growing number of voluntary codes in financial markets explicitly aiming to improve sustainability performance, such as the Equator Principles (project finance), the Principles for Responsible Investment and the Principles for Sustainable Insurance. Much could be learned by investigating the dynamics between these two realms.

The operating procedures and structures that link the policy institutions overseeing the financial system with those driving the transition to a green economy will also need to evolve to deliver effective joined-up governance. This is increasingly recognised as part of the discussions on financing the post-2015 sustainable development goals: “a strengthened financing framework would ask the question of how to create a global financial system – including its public, private, domestic, and international components – that incentivizes investors and other stakeholders to act in the interest of global sustainable development.”<sup>xii</sup> In addition, in climate finance discussions OECD ministers agreed in May 2014 to “better aligning investment and climate policies to support an effective partnership among governments, development partners, and the private sector in order to incentivise private investment in low-carbon and climate-resilient infrastructure.”<sup>xiii</sup>

The specific mandates of the institutions that supervise the financial system could also need review and refinement. Across the world, policy makers and regulators often have a mix of financial and real economy goals within their mandates, including price stability, economic growth and employment, as well as inclusion and sometimes priority sectors such as agriculture and SMEs. There are few instances, however, of mandates extending to environmental outcomes, with the limit in most cases being restricted to requirements for regulated institutions to report on environmental policies and risk assessments. This shortfall is apparent both in terms of explicit environmental and associated economic goals, and also in the narrower sense of even assessing the impacts of financial policies and regulations on sustainability outcomes. Furthermore, interpretations of macro-prudential roles have to date not incorporated sustainability challenges into the assessment and management of systemic risks. And the frameworks for assessing financial policy performance and ensuring accountability rarely incorporate the implications for green economy outcomes.

Research questions	Implications for policy and practice
<p>5. <b>Should, can and do international finance governance institutions and processes take social and environmental issues into account?</b></p> <p>6. <b>How does, can or should analysis of systemic risk under macro-prudential regulation take social and environmental matters into account?</b></p> <p>7. <b>Do different configurations of financial policy and regulatory authorities impact their capacity to address environmental and social objectives?</b></p> <p>8. <b>What is the case for (and against) and practice of central banks and financial regulators directly and indirectly pursuing environmental and social objectives?</b></p> <p>9. <b>What is the impact of differing forms of, and policy approaches to, credit creation on environmental and social outcomes?</b></p>	<p>How could the mandates for rule setters and the rules and principles of the financial architecture be updated to take account of the systemic risks associated with the financial system's impact on green and inclusivity outcomes, and vice versa?</p>

### **Responsibilities, incentives, information: steering financial institutions**

Increasingly, environmental and social factors have become material for capital allocation, driven by a range of factors including physical, regulatory, market and reputational risks. For institutional investors, there are promising signs of links being made between fiduciary duty and sustainability. But these remain largely at the margin – and this gap between theory and practice suggests the need for an authoritative statement of fiduciary duty and sustainability to guide practical and prudent decision-making. For banks, the evolution of green credit guidelines in the developing world points to a way in which environmental and social factors could become part of routine governance and decision-making.

In policy-directed financial institutions, such as development finance institutions and sovereign wealth funds, extended and multiple objectives are of course generally expected, including goals linked to sustainable development. The Inquiry needs to explore the experience of such extended mandates of financial institutions, their impact on capital allocation, risk-adjusted financial returns and the sustainability features of the investments, and the manner in which they has been achieved, that is, the modalities of implementation.

Capital allocation is also driven by incentives, whether through direct remuneration or indirectly via fiscal measures. Yet there remains a gap in our understanding of aligning incentives to longer-term performance that would value enhanced green and inclusive outcomes in the real economy. Governments have historically used fiscal mechanisms to steer capital towards specific real economy outcomes, notably to support the roll-out of public infrastructure. Tens of billions of dollars are allocated by governments to

encourage savings and investment, but the direct and indirect links with the transition to a green economy remains unclear.<sup>xiv</sup> A range of fiscal instruments are used to mobilise capital for the green economy – such as tax credits for renewables – but few are focused directly on the underlying providers of capital, such as savers. In addition, attempts to introduce fiscal measures to dampen excess short-term trading – for example through the so called Financial Transactions Tax - have so far also become mired in legal and technical debate. Alignment to the green, inclusive economy has not been the main focus of these efforts, which have been framed rather in terms of investor, taxpayer and system risks.

Incentives embedded across corporations and financial institutions have become a hotly debated topic in the wake of the financial crisis. Linking remuneration with long-term performance and sustainability is still an embryonic work in progress: amongst the S&P500 companies in the USA, for example, there are fewer than 10 companies that incorporate sustainability factors into long-term incentives for senior management.<sup>xv</sup> And incentives cannot be separated from the metrics and benchmarks that are used to assess financial performance. Market innovation has delivered an array of investment benchmarks that incorporate sustainability, climate and social factors. But the mainstream indices that drive capital allocation by institutional investors still do not reflect the economic reality they are trying to measure, are biased towards the past and do not incorporate the green economy: “capital is channeled disproportionately into old economy companies rather than green economy companies, and companies that may wish to move strategically in line with sustainable development find little incentive from stock and bond markets to do so”.<sup>xvi</sup>

Research questions	Implications for policy and practice
<p><b>10. How do fiscal support and incentives directed at the financial sector, and beneficiaries of financial products impact on environmental and equity outcomes?</b></p> <p><b>11. How does, can or should investor governance and associated public policies take social and environmental matters into account?</b></p> <p><b>12. What is case for (and against) and practice of different approaches to policy-incentivized lending in addressing social and environmental objectives?</b></p>	<p>How could policy mechanisms and fiscal incentives for credit creation, savings, investment and pensions, as well as investor governance, associated public polities support the long-term transition to a green, inclusive economy?</p>

### Tomorrow’s Financial System and Change Pathways

While the inquiry is concerned with the ‘design of a sustainable financial system’, this does not imply a blueprint. Rather, it is recognised that the financial system evolves through innovation and response to diverse interests and needs. The well-known adage that one should not “design solutions to yesterday’s crisis” is profoundly true in the case of the financial system. An *efficient* regulatory regime deals competently with ‘what is’, but a *resilient* regime needs to be able to deal competently with what arises next. Therefore, to be truly effective, financial policy and regulation must be forward-

looking and prepared to accept the challenge of keeping pace with disruptive innovation – both realised and potential.

Within the financial system itself a number of disruptive trends are underway. One example is technology-driven disintermediation, which has the potential for transforming the institutional architecture of major parts of the financial system. The emergence of peer-to-peer lending and other financial services, crowd-funding, impact investing and privately issued crypto-currencies could stimulate a transformation of the financial system, allowing for more effective business models, including new actors with diverse interests. At the other end of the spectrum, the growing importance of policy-driven financial institutions establishes a counter-point to this trend towards disaggregation, inserting centralised interests at key points of leverage in the system.

Complicating dynamics are also at play in the real economy. Growing intra-country inequality is socially undesirable and a drag on economic growth. It can lead to political instability just as strong political leadership becomes essential to drive forward needed changes. Technological intensification, notably the expected surge in automation across broad swathes of industry and services, may be cost effective and even carbon mitigating, but is undermining the role of employment in providing sustainable livelihoods. Climate change itself will be both a cause of growing destructive disruption, and may also shape structural changes in our global economy.

Clearly, policy interventions need to strike a difficult balance between encouraging productive financial innovations, whilst also curbing those that threaten the integrity of the system. Addressing the long-term needs of the green economy is highly unlikely to succeed through exclusively, compliance-focused interventions. Much of what has delivered investment in the green economy to date, for example in the renewables field, has benefited from financial innovation, both at the instrument level, and in the institutional constellations that have developed and deployed such instruments. The next phase will certainly require further financial innovation, for example, around green bonds and debt capital markets.

Research questions	Implications for policy and practice
<p><b>13. How might and could technology and institutional innovations in the financial sector impact social and environmental outcomes?</b></p> <p><b>14. How best can financial policy and regulation aimed at social and environmental outcomes be sequenced and how can trade-offs be understood?</b></p> <p><b>15. What is the role of citizens as consumers, investors, employees and/or as social movements in effecting the financial system's impact?</b></p>	<p>How best can financial system evolution be advanced, given the opportunities and threats to sustainability implied by existing change dynamics?</p>

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- <sup>ii</sup> Carbon Tracker and the London School of Economics (2013) Unburnable Carbon 2013: Wasted capital and stranded assets. London: LSE.
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- <sup>v</sup> 2 Degrees Investing (2013). Shifting Private Capital Towards Climate Friendly Investments: The Role of Financial Regulatory Regimes. Paris: 2 Degrees Investing.
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- <sup>vii</sup> Kay, J. (2012). The Kay Review of UK Equity Markets and Long-Term Decision Making. London: UK House of Commons Business, Innovation and Skills Committee.
- <sup>viii</sup> G30 Consultative Group on International Economic and Monetary Affairs (2013). *Long Term Finance and Economic Growth, Twelfth Report of Session 2013-14. Volume 1*. Washington D.C.: Consultative Group on International and Monetary Affairs.
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- <sup>xii</sup> UN (2014) Coherence, coordination and cooperation in the context of financing for sustainable development and the post-2015 development agenda. Note by the Secretary-General. New York: ECOSOC, 27 March 2014 .
- <sup>xiii</sup> OECD (2014). OECD Ministerial Statement on Climate Change Paris: OECD
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- <sup>xv</sup> Hewitt, G. (2014). Sustainability metrics in Executive Pay: short-term focus on a long-term issue. GMI Ratings.
- <sup>xvi</sup> Zaouati, P. and Joly, C. (2014). EC legislation to regulate financial indexes, in Visser, W. (ed) *Disrupting the Future*, <http://www.2052.info/disrupting-the-future/>