



Sustainable Finance – A tool for shaping the future

Coming from an ‘empty’ world with abundant natural resources, the Industrial Revolution has brought prosperity in the form of economic and population growth. At the same time, this growth - based on production processes dependent on fossil fuels and other natural resources- has created social and environmental challenges. Mass production in a competitive economic system has led to long working hours, underpayment and child labour, first in the developed world and later relocated to the developing world. Social regulations are increasingly introduced to counter these practices and promote decent work and access to education and healthcare. Mass production and consumption is stressing the Earth system through pollution and depletion of natural resources. Climate change is now the most pressing ecological constraint or planetary boundary. To address these social and environmental challenges in our economic system, the United Nations has developed the Sustainable Development Goals for 2030. Sustainable development means that current and future generations have the resources needed, such as food, water, healthcare and energy, without stressing the Earth system processes

Our economic models were developed in a world with an abundance of goods and services produced by nature. That was at the onset of the Industrial Revolution in the 19th century. Labour and capital were the scarce production factors to optimise in economic production, while nature and its services were freely available. The current linear production and consumption system is based on extraction of raw materials (take), processing into products (make), consumption (use) and disposal (waste). Traditional business models centred on a linear system assume the on-going availability of unlimited and cheap natural resources which is emerging as a challenge and significant risk.

Why sustainability matters ?

“It matters more than it ever has,” says Will Day on sustainability. The head of the UK’s Sustainable Development Commission. Sustainability is important for a very simple, very straightforward reason: we cannot maintain our quality of life as human beings, the diversity of life on Earth, or Earth’s ecosystems unless we embrace it. There are indications from all quarters and from the smallest to the largest scale that sustainability is something we must address. We will run out of fossil fuels. Thousands if not millions of animal species will become extinct. We will run out of lumber. We will damage the atmosphere beyond repair... If we don’t change. And the root of that change lies in understanding and striving for sustainability—in our own homes, in our communities, in our ecosystems, and around the world. Sustainability is a major challenge, one that matters beyond individual companies. But reassuringly a number of large companies are developing forward-thinking sustainability policies. It is really becoming clear that sustainability is a megatrend that simply isn’t going away!

What is Sustainable Finance?

Sustainable finance refers to any form of financial service integrating environmental, social and governance (ESG) criteria into the business or investment decisions for the lasting benefit of both clients and society at large. Sustainable finance is the provision of finance to investments taking into account environmental, social and governance considerations

Sustainable finance includes a strong green finance component that aims to support economic growth while

- reducing pressures on the environment
- addressing green-house gas emissions and tackling pollution

- minimising waste and improving efficiency in the use of natural resources

It also encompasses increasing awareness of and transparency on

- the risks which may have an impact on the sustainability of the financial system
- the need for financial and corporate actors to mitigate those risks through appropriate governance

The role of the financial system in sustainable development

Finance is a key lever for change in sustainability and plays a major role in shaping the world we live in. The financial system can make a difference to our current economic model. It can significantly influence sustainable development by not only better integrating environmental risk, but delivering mechanisms that protect nature and drive sustainable business practices. How can the financial system facilitate decision-making on the trade-offs between economic, social and environmental goals? Levine (2005) lists the following functions of the financial system:

- Produce information ex ante about possible investments and allocate capital;
- Monitor investments and exert corporate governance after providing finance;
- Facilitate the trading, diversification, and management of risk;
- Mobilise and pool savings;
- Ease the exchange of goods and services.

The first three functions are particularly relevant for sustainable finance. The allocation of funding to its most productive use is a key role of finance. Finance is therefore well positioned to assist in making strategic decisions on the trade-offs between sustainable goals. While broader considerations are guiding an organisation's strategy on sustainability, funding is a lever for reaching sustainable goals. Finance plays this role at different levels. In the financial sector, banks, for example, define their lending strategy regarding which sectors and projects are eligible for lending and which not. Similarly, investment funds set their investment strategy, which directs in which assets the fund invests and in which assets not. The financial sector can thus play a leading role in the

transition to a low-carbon and more circular economy. If the financial sector chooses to finance sustainable companies and projects, they can accelerate the transition. In terms of monitoring their investments, investors can also influence the companies in which they invest. Investors thus have a powerful role in controlling and directing corporate boards. The governance role also involves balancing the many interests of a corporation's stakeholders.

Sustainability is about acknowledging the important role we can play in catalyzing capital to help address issues facing our society today — from the environment to health care to urban development. If we are serious about delivering superior long-term shareholder returns, we must continue to focus on managing ourselves responsibly and identifying opportunities to allocate capital more purposefully across our businesses.

The main definitions concerning sustainable finance

Sustainable Development: an economic development model aimed at meeting the needs of present generations without jeopardising the needs of future generations.

Sustainability/ESG Factors: aspects of Sustainability that encompass the environmental, social and corporate governance dimensions (Environmental, Social, Governance - ESG).

Sustainability Finance: establishes how the concepts of Finance and Sustainable Development interact, in other words, the application of the Sustainable Development model to Finance.

Sustainable Investments: investments that include, at least one of the Sustainability/ESG factors. Sustainability: application of the Sustainable Development model in the private, public and tertiary sectors.

Sustainable Finance Products and Services: financial products and services that include environmental, social and/or corporate governance criteria, in other words that include at least one of the Sustainability/ESG Factors.

Why should finance contribute to sustainable development?

The main task of the financial system is to allocate funding to its most productive use. Finance can play

a leading role in allocating investment to sustainable corporates and projects and thus accelerate the transition to a low carbon and more circular economy. Sustainable finance looks at how finance (investing and lending) interacts with economic, social, and environmental issues. In the allocation role finance can assist in making strategic decisions on the trade-offs between sustainable goals. Moreover, investors can exert influence on the corporates in which they invest. In this way, long-term investors can steer corporates towards sustainable business practices. Finally, finance is good at pricing risk for valuation purposes and can thus help dealing with the inherent uncertainty about environmental issues. Finance and sustainability both look at the future. The thinking about sustainable finance has gone through different stages over the last decades, whereby the focus is gradually shifting from short-term profit to long term value creation

In the emerging global Financing Challenge Harnessing the nearly US\$300 trillion global financial system is essential if countries are to make a rapid and orderly transition to a prosperous, inclusive and sustainable economy. Over the past decade, there have been increasing efforts by financial institutions, as well as steps taken by central banks, financial regulators and market standard setters, to align the financial system with long-term sustainable development. This is being driven by the growing acknowledgement of the value of sustainability factors for efficient capital allocation to the real economy, the delivery of risk-adjusted returns, the management of emerging threats and the strengthening of economic governance

The 5Rs of Sustainable Financial Systems

Reallocation Financing a sustainable economy will require the efficient reallocation of capital to critical priorities including improving access to green finance, raising capital for sustainable infrastructure, and financing critical areas of clean tech innovation

Risk Sustainability factors are increasingly being considered as relevant factors for risk management within financial domain. Experience is extending from project analysis through portfolio assessment to system level stress tests for issues across the spectrum of sustainable development issues.

Responsibility Growing numbers of financial institutions are adopting shared principles that

guide the integration of Environment, Social, Governance factors. Policymakers are often supporting this process through policy interventions in Banking Insurance Capital markets Reallocation, Risk Reporting, transparency and governance

Reporting The financial system relies on information flows to enable the efficient allocation of capital and ensure accountability. Market approaches to disclosure are increasingly moving towards Environment, social and Governance dimensions.

Roadmaps Many countries have elements of a strategy for sustainable finance – but often need a process to ‘join the dots’ across key sectors and issues – taking stock of current state and practices and identifying next steps.

Three stages of sustainable finance

At the level of the economy, the financial return and risk trade-off is optimised. This financial orientation supports the idea of profit maximisation by organisations and economic growth of countries. Next, at the level of society, the impact of business and financial decisions on the society is optimised. And finally at the level of the environment, the environmental impact is optimised. There are interactions between the levels. It is thus important to choose an appropriate combination of the financial, social and environmental aspects

Challenges to integration of sustainability into finance

Corporates play a key role in the transition to a sustainable economy. It is therefore important to broaden their objective from shareholder value to stakeholder value, which integrates financial, social and environmental value. Another challenge is a behavioural bias towards the short term. Market practices, like monthly or quarterly performance benchmarking and variable pay, reinforce this short-term bias. A possible cost of financial markets is thus short-termism, with agents in the financial intermediation chain weighing near-term outcomes too heavily at the expense of longer-term opportunities. But sustainability is about the long term

Sustainability needs to be incorporated in mainstream finance. At the basic level (SF 1.0),

exclusion of companies or projects with very negative social or environmental impact is incorporated in the investment, lending or insurance strategy. The next level (SF 2.0) incorporates ESG factors and risks in the decision-making and manages the integrated value. The advanced level (SF 3.0) starts with an analysis of the social and environmental impact before considering financial returns

Mainstreaming of sustainable finance

Sustainable finance has leapt from 'niche' to mainstream with lightning speed. Sustainable finance is currently one of the most widely discussed issues in the Global financial system.. Continued decisive action, both at the policy and market levels, will contribute to maintain the momentum achieved. Such action could include the pricing of climate-related risks, mobilizing finance, and ensuring that sound underlying policies with clear and harmonized definitions are used across jurisdictions.

Sustainable finance can provide ways to address income inequality and meet the basic needs for all people. Through a combination of public policy mechanisms and financial innovation, policymakers should ensure that coherent climate and investment policies, along with effective fiscal reforms, are working together to facilitate a just transition to a low-carbon economy. Financial innovations such as social impact bonds and sustainability bonds can also play a crucial role.

Emerging markets around the world are beginning to view sustainable finance as an opportunity. It can drive the innovation that leads to job creation and new industries. Multilateral development banks

(MDBs) can help foster sustainability in emerging markets, particularly by leveraging private sector finance, but tensions exist – debt, transparency and capacity to name a few. The momentum is positive, but has not yet achieved a systematic impact.

Conclusion

Sustainable finance refers broadly to the process of taking into account environmental and social considerations in investment decisions. The growing momentum towards sustainable finance is clear: integrating ESG factors into investment portfolios is delivering superior returns ; the green bond market continues to expand ; governments are developing national sustainable finance roadmaps; and, financial regulators are incorporating environmental risks into market supervision. Sustainability factors are becoming material for the competitiveness of financial centres.

Traditional finance focuses solely on financial return and risk. By contrast, sustainable finance considers financial, social and environmental returns in combination. Seeing the role of finance as one of allocating funding to productive investments in a narrow sense is no longer appropriate. What constitutes 'productive' cannot be independent of a project's environmental and socio-economic impact because there are often trade-offs between short-term profits and long-term impact. What might appear to be a profitable project over a given time period could have negative impacts that might only become apparent in the longer term. Using finance as a means to achieve social goals we can divert the planet and its economy from its current path to a world that is sustainable for all.

