Overarching Visions

G20 Japan

Turning Sustainable Finance into Mainstream Finance

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We propose sustainable finance to become mainstream finance. Embedding environmental, social and governance (ESG) principles in a new normal for finance will facilitate its alignment with the broader objectives of society, the engagement of the private sector within the sustainability discussion and action plans, including the Agenda 2030; and by systematically pursuing risk reduction and the provision of stable long term returns, the achievement of the G20´s goal of "solid, balanced, sustainable and inclusive growth". We propose the G20 to support the process by providing a comprehensive conceptual vision, an evolving roadmap, operational coordination and forward guidance to the multiple actors involved as well as the problem-solving capacity to tackle the numerous obstacles that will emerge in this transition.

Challenge

The economy and the financial system are complex adaptive systems subject to continuous change. Fitness in such ecosystems requires not only efficiency but sustainability. The Great Financial Crisis (GFC, 2007-2009) exposed that existential perils might grow – and accumulate unobserved – even when remarkable economic success is recorded. Nonetheless, those risks can be triggered at no notice and, given their non linearity, rapidly put the whole global financial system – and the world economy – on the brink (1). One decade after the GFC– even if a depression was avoided– economic performance remains mediocre, trust in finance has not been restored, and the political situation has entered an unchartered phase of high uncertainty.

Non strictly financial variables – environmental, social and governance factors – are stressing the system, have proven to be increasingly material (2), and could become critical, but they are not integrated within the conventional finance framework. Seventeen of the 18 warmest years in the 136-year record between 1884 and 2017 all have occurred since 2001, with the exception of 1998 (3). The frequency of extreme weather events causing $1 billion or more in losses has risen sharply over the past decade (4) . Even central banks acknowledged that the topic falls within their mandates. Not just for financial stability motives but also due to its potential consequences for the design of monetary policy (5). Moreover, governance was a huge mess behind the scenes in the genesis of the GFC. Last but not least, the lack of attention to social impact has cost dearly. Social and political divides have emerged threatening the very foundations of the economic and political national regimes (and by doing so, the established cooperative international order).

A more resilient ecosystem is needed. The globally agreed framework for sustainability is the Sustainable Development Goals (SDGs), launched in 2015. The SDGs aim to create a viable model for the future in which "all economic growth is achieved without compromising our environment or placing unfair burdens on societies" (6). So, mainstreaming sustainable finance is the logical next step. Coupled with strong financial governance reform (7), it might not only achieve a better risk/reward performance but provide a set of societal values and norms consistent to beliefs, and with them a sense of purpose. Having a sustainable anchor, and the goals of society as its master, a trustworthy financial system could re-emerge.

Proposal

We propose the G20 to support the mainstreaming of sustainable finance by providing a comprehensive conceptual vision, an evolving roadmap, operational coordination and forward guidance to the multiple actors involved as well as the problem-solving capacity to tackle the numerous obstacles that will emerge in this transition.

We think that mainstreaming sustainable finance requires the articulation of bold innovative decisions, policies and procedures by many different players within the public and the private sector, as well as civil society, both at the national and international level. The G20 is exceptionally well positioned to lead this complex evolving process through its experience, vision and political reach. Sustainable finance is part of its agenda and the G20 has already started working in the right direction.

China´s presidency of the G20 brought green finance8 decisively into the G20 agenda by setting a special dedicated study group in 2016. Under Argentina´s presidency two years later, members decided to widen the scope of that stream of work by replacing it with the Sustainable Finance9 Study Group (SFSG). The SFSG addressed specific sustainability-related challenges in three areas: creating sustainable assets for capital markets; developing sustainable Private Equity and Venture Capital (PE/VC); and exploring potential applications of digital technologies to sustainable finance, taking into account specific countries' circumstances, priorities and needs (10).

Building up on this momentum, we recommend the creation of a Sustainable Finance Working Group (SFWG) and assign it the task to develop an architectonic vision on how to put finance to work for sustainability, outline steps for comprehensive ESG integration across the entire financial system, and elaborate an Action Plan for the G20 to advance this agenda (with active public sector/private sector/civil society participation).

We exhort the G20 to pari passu build a narrative on sustainability as an anchor of the social contract to increase public awareness on the role of the SDGs and the Agenda 2030, the importance of meeting present needs without compromising the ability of future generations to meet their own needs, and the imperative to align finance (and economic growth, in general) with the broadest objectives of society. That narrative should provide attraction, and social traction, in order to reach the critical support mass needed to drive change, and to avert occasional political setbacks.

We propose the G20 to act as a catalyzer to accelerate the pace of transformation but also as a consolidator – a credible reference to avoid dispersion and fragmentation – capable to provide policy signals and consistent forward guidance, as well as to prevent deviations like "Green/ ESG/ SDGwashing".

We propose these key elements to be considered:

First of all, get the incentives right. Pricing risk should be a priority. When dealing with externalities, policies that attack the roots of the issues are always preferable. Only when this is not possible, second best policies are advisable. To have the pricing right is key not only to impulse switching towards responsible consumption and production, but to propel capital allocation and new investment towards sustainable sectors, activities and procedures (those that should expand).

Provide a sense of the dynamics in play, even if pricing is imperfect or highly uncertain. Try to internalize the fact that in issues such as global warming any delays in the commitment to mitigation measures will only increase the cost borne by society.

In a race against time, technological change (11) **is the wild card. But the right incentives are required to speed it up (towards the right direction).**

Huge risks open the door to big opportunities. Stress both. Succesfully exploiting those opportunities could avoid risks altogether. This is especially important when considering the huge needs of investment in sustainable infrastructure.

Incentivise financial innovation – such as fintech and digitalisation – that could provide new instruments, resources and solutions to advance the ESG agenda.

Commit the whole society in this endeavor. This is too large an issue for the public sector to handle it alone (with consequences falling on the next generations). Engage the private sector and civil society. Take demographics into account as well as gender trends. The SDGs set an extraordinarily ambitious agenda: the UN Commission on Trade and Development (UNCTAD) estimates that it will require US$5 trillion to US$7 trillion in investment each year from 2015 to 2030. That will be only possible with the involvement of the private sector. But do not forget to align the public sector.

To accelerate the agenda join and forge strategic alliances with key actors. Consider the leveraging power of a joint public sector/ private sector alliance able to comprise 20 globally-systemic banks, 8 of the top 10 global asset managers, the world's leading pension funds and insurers, the largest sovereign wealth fund and the two dominant shareholder advisory service companies – among other nearly 100 top international companies – , with the backing of governments, the United Nations and the World Bank. At the first One Planet Summit, held in Paris in June 2017, such alliance (12) –that included financial institutions responsible for managing US$80 trillion of assets – publicly supported the Task Force for Climate-related Disclosures (TCFD) (13). New supporters are added on a continuous basis (14).

Let markets play a significant role, their main expertise is on allocating capital under uncertainty. But provide them with the best inputs possible. The steady increase of ESG investing15 within financial capital markets is linked with the fact that ESG assets have performed better than their traditional counterparts16 without experiencing more risk as a trade off.

Build market discipline based on solid information and risk disclosure. We strongly support the work of the Financial Stability Board (FSB)´s TCFD, and consider it a key pillar in order to achieve a reliable framework for green and Development/Crypto-assets and Fintech finance. It has developed recommendations for voluntary climate-related financial disclosures that are consistent, comparable, reliable, clear, and efficient, and provide decision-useful information to lenders, insurance underwriters and investors. This information is essential for risk management purposes (17).

Propel sustainable investing under the Principles of Responsible Investing (PRI). Signatories commit to six voluntary principles, the first of which is the incorporation of ESG issues into investment analysis and decision-making. Since its founding in 2006, the PRI has attracted support from more than 1,800 signatories representing over USD $68 trillion in assets under management. According to the Global Sustainable Investment Alliance (GSIA), there are now $22.89 trillion of assets being professionally managed under responsible investment strategies in the whole world, an increase of 25 percent since 2014. In relative terms,responsible investment now stands at 26 percent of all professionally managed assets globally. This a successful platform that should be escalated further.

Policy intervention is needed. Use normative and regulation to nudge for change. It is advisable to correct evident market failure and to provide the initial spark when there is market consensus but, nonetheless, leadership is needed as a trigger. Do not cede to the temptation of overusing it. Keep in consideration the potential negative side effects it might cause.

Integrate ESG into the management of public balance sheets– both through the investment process as well as through voting shares – including those of public pension funds, sovereign wealth funds, central banks, and other government institutions.

Make ESG information mandatory component of corporate reporting (18) ande**nhance transparency.**

Other levers should be used to achieve sustainability apart from finance. Some of them might complement finance in a mutually reinforcing way. Fiscal policy, for example. The G20 should identify those nexus and promote synergy.

Take impact as the ultimate arbiter of success. Given that so many numbers, definitions and diverse criteria are on the table sorting out confusion and ambiguity should be an important deliverable. You can only manage what you can measure, the saying goes. But you have to measure what is relevant, and while you can use many proxies to estimate success, the effective impact has to become the unit of measurement.

In addition to the above-mentioned elements, we also propose for the G20 to endorse the following three concrete policy recommendations.

Expand the scope of the TCFD to go beyond climate risks towards a complete coverage of ESG risks. The TCFD was inspired by the experience of the Enhanced Disclosure Task Force (EDTF) also established by the FSB at a request of the G20 after the GFC. The EDTF's recommendations, published in October 2012, were the product of collaboration between banks, analysts and investors. They gave the providers of capital the disclosures they needed – specifically how banks manage risks and make profits – in a format that the banks could readily supply. In December 2015 the FSB published a third – and last – progress report by the EDTF of implementation by major banks of its Principles and Recommendations on Risk Disclosures (19).

In the same tradition, we propose to broaden the scope of coverage of the TCFD by establishing a new industry-led Task Force on ESG-related Financial Disclosure (TEFD) aimed to elaborate principles and recommendations on ESG-related risks and opportunities. Initially it should focus on those not climate-related, that fall outside the reach of the TCFD. Given that those risks and opportunities are of different nature, a partially different Task Force composition (and specific agenda) might be warranted. Later on, it could be operational to merge both Task Forces (especially if risk correlations prove to be significant). Alternatively, it could happen that different degrees of implementation of their recommendations – according to their periodical reports – justify dissolving one of them, and extending the validity of the other.

Extend the use of stress testing and scenario analysis to assess the impact of ESG risks under extreme conditions. Stress testing could be particularly useful to identify the impact of tail risks (20). Banks and insurance companies are regularly subject to stress tests by their own regulators and supervisors. Either those exams should be reconfigured to add coverage of ESG risk exposure (which would be our preferred choice) or a separate layer of ESG specific tests should be addressed (maybe at different time intervals). We envision a future where (1) conventional stress tests go system wide (involving other financial players such as asset management companies and pension funds) and (2) they add an ESG dimension. We do understand that it takes time to develop a methodology on a new field of analysis until it proves to be reliable and becomes fully integrated, but we believe that the goal should be set in advance.

Stress testing and the use of scenario building analysis (21) are means to identify material risks but also to nurture the strategic planning process. Scenario analysis evaluates a range of hypothetical outcomes by considering a variety of alternative plausible future states (scenarios) under a given set of assumptions and constraints22. Its purpose is to understand how a business might perform under different future states, for example, in terms of resiliency or robustness. Forward looking and data driven exercises should follow Task Forces´ recommendations (such as TCFD´s), in order to reveal to a company´s board (and stakeholders) the short and long term ESG risks of their businesses. These risks should be integrated with the company`s risk management practices. Ideally, responsibility should be assigned to one senior member of the Board.

Such information made public would enhance transparency and be useful for banks, investors and insurers, and for capital markets in general, influencing the cost of capital and easiness to access to short term and long term financing.

Redefine fiduciary duties with an ESG perspective. Policy makers should clarify the duty of asset managers and institutional investors to take ESG factors into account. Two persistent misconceptions negatively affect the way many fiduciaries think about sustainable investing: (1) fiduciary duties block a fiduciary investor from considering environmental and social factors and (2) if a fiduciary investor engages in sustainable or responsible investing, the portfolio will suffer financially (23). Neither of these assumptions is correct (24).

When evaluating whether or not an institutional investor has delivered on its fiduciary duties, both the outcomes achieved and the process followed are of critical importance. As we have already highlighted, there is growing recognition that ESG integration does not come at a cost and may in fact enhance risk-adjusted returns. The SEC already requires companies to report material information, and reporting standards developed by the Sustainable Accounting Standards Board (SASB) and the Global Impact Investing Network (GIIN) are improving the understanding of the financial materiality of ESG factors (25).

A 2005 report commissioned by the the United Nations Environment Programme Finance Initiative (UNEP FI)26 concluded that integrating ESG considerations into investment analysis is "clearly permissible and is arguably required (27)."Available data explains why a prudent investor should consider ESG information. Moreover, the duty of impartiality protects future beneficiaries, duty that requires a long-term investment time horizon, increasing the need to take ESG factors into consideration. It follows that a prudent fiduciary investor not only may, but should, use ESG information in developing financial policy and decisions (28).

We propose that the SFWG to develop a Fiduciary Duty Chapter, a set of written statements, explaining why (1) a prudent fiduciary investor should use ESG information both to formulate its financial policy guidelines and adopt financial decisions, (2) the importance of ESG factors to mitigate risk and achieve stable long term results as well as detailing (3) the solid foundations and enhanced practices of sustainable investing.

Notes

1 In what the literature calls a Minsky moment.

2 For financial analysis and decision making. See "Why and How Investors Use ESG Information: Evidence from a Global Survey." Harvard Business School Working Paper, February 2017.

3 Source: NASA /GISS. https://climate.nasa.gov/vital-signs/global-temperature/

4 Source: National Oceanic and Atmospheric Administration (NOAA). Cited in Adapting Portfolios for Climate Change, BlackRock Investment Institute Global Insights, September 2016.

5 "The global financial crisis has shown that extreme events can quickly erode central banks' conventional policy space. Catastrophic climate change could thus test the limits of how far monetary policy can go and, in the extreme, force us to rethink our current policy framework.", Speech by Benoît Cœuré, at a conference on "Scaling up Green Finance: The Role of Central Banks", Berlin, 8 November 2018.

6 The SDG Investment Case. https://www.unpri.org/sdgs/the-sdg-investmentcase/303.article

7 Along the lines of the reform proposed by the G20 Eminent Persons Group Report of Global Financial Governance (October 2018) which uses the SDGs as it "fit-for-purpose" test.

8 Green finance is defined as finance that delivers environmental benefits in the context of sustainable development.

9 Sustainable finance looks more broadly at environmental, social and governance (ESG) factors.

10 Sustainable Finance Study Group. Synthesis Report. July 2018.

11 See, for example, geoengineering. Geoffrey Heal, "The Economics of the Climate", Journal of Economic Literature 55 (3), pp. 1046–63.

12 For the list of signatories see https://www.fsb-tcfd.org/statement-support-supportingcompanies-june-2017/

13 "In signing this statement, we affirm our commitment to support the voluntary recommendations of the industry-led Financial Stability Board (FSB) Task Force on Climate-related Financial Disclosures (TCFD). We believe that climate change will have significant impacts across many sectors and that we, as business leaders, have an important role to play in ensuring transparency around climate-related risks and opportunities...We encourage other business leaders to join us in this united effort to improve disclosure across sectors and regions." Statement of Support for the TCFD Recommendations (Final TCFD Report Launch June 2017). Ibidem.

14 More than 580 organizations are supporting the TCFD as of February 2019. https://www.fsb-tcfd.org/tcfd-supporters/

15 ESG investing – or sustainable investing, or socially responsible investing or missionrelated investing, often used as synonyms – is the consideration of environmental, social and governance (ESG) factors alongside financial factor in the investmente decisionmaking process., according to MSCI ESG Research. https://www.msci.com/esg-investing

16 ESG drives outperformance as 'social' focus begins to see gains https://www.investmentweek.co.uk/investment-week/news/3066178/esg-drivesoutperformance-as-social-focus-begins-to-see-gains

17 Companies can more effectively measure and evaluate their own risks and those of their suppliers and competitors. Investors will make better informed decisions on where and how they want to allocate their capital. Lenders, insurers and underwriters will be better able to evaluate their risks and exposures over the short, medium, and long-term.

18 France passed a law mandating climate risk reporting for big business in 2015. The UK government has resisted such calls. See "UK government fails to make climate risk reporting mandatory" http://www.acclimatise.uk.com/2018/11/12/uk-government-failsto-make-climate-risk-reporting-mandatory/

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19 The progress report reinforced the continued increase in implementation of the EDTF recommendations by banks, and a further survey was deemed unlikely to deliver significant increases. So, the FSB formally disbanded the Task Force.

20 "Stress-testing technology is well-suited to analysing tail risks likely to grow fatter with time, casting light on the future implications of environmental exposures embedded in a wide range of firms and investments". https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizonclimate-change-and-financial-stability

21 The purpose of scenario analysis is to consider and better understand how a business might perform under different future states (i.e., its resiliency/robustness).

22 https://www.fsb-tcfd.org/publications/final-technical-supplement/

23 Susan Gary, Best Interests in the Long Term: Fiduciary Duties and ESG Integration, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3149856

24 Ibid.

25 Susan Gary, Best Interests in the Long Term: Fiduciary Duties and ESG Integration, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3149856.

26 From law firm Freshfields Bruckhaus Deringer

27 https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century/244.article

28 Susan Gary, ibidem.

Existing Initiatives & Analysis