Input from the Netherlands to the UNEP Inquiry into the Design of a Sustainable Financial System

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Introduction

1. In 2014 the UNEP initiated the Inquiry into the Design of a Sustainable Financial System. The UNEP Inquiry is intended to accelerate the transition to a green and circular economy by better aligning the financial system through identifying best practices and exploring financial market policy and regulatory innovations. The Inquiry will do this through an advisory council, practitioner dialogue and research. At the October 2015 IMF and World Bank meeting in Lima it will lay out options for advancing a green financial system.
2. From several countries experts from the financial sector have given input to the Inquiry. On invitation of the Sustainable Finance Lab, sponsored by the Dutch ministry of Infrastructure and the Environment, FMO and nine other private financial institutions, the Inquiry's co-director Simon Zadek visited the Netherlands on May 26 to meet with 20 representatives from the Dutch financial sector (see annex for the list), ranging from public rule makers and regulators to the largest banks, asset managers, insurance companies and sustainable frontrunners. A follow up meeting will take place on November 27 and will be hosted by the president of the Dutch central bank (DNB) Klaas Knot.
3. This note summarizes the input that the different participants of the May 26 meeting gave to the Inquiry. It contains best practices, financial market policy and regulatory innovations that participants think will help bringing about the green economy and the sustainable financial sector all want to see realized. The aim of this note is to provide the Inquiry with input that can be used for finalizing its report over the coming months. It should be clear that not all points described here are necessarily underwritten by all present.

On the need for finance to become more involved in the sustainability transition

4. There is a broad recognition of the analysis of the Inquiry that we are currently overinvesting in economic activities with too many negative social and environmental externalities and underinvesting in economic activities that deliver on urgent social and ecological needs.
5. The current credit and investment portfolios are predominantly in the old linear economy. The coming decades the transition to a more green and circular economy will be made. The role of the financial sector will be to enable this transition. The financial sector has a fiduciary duty to make sure that the financial system is ready for this transition. At the moment this is insufficiently the case.

6. However, several Dutch financial institutions have recently set ambitious targets. PFZW, the pension fund for the healthcare sector, set as its goal to halve the carbon emissions of its portfolio in 2020 and raise its impact investments of 3% to 12%. The ASN Bank aims to be climate neutral with all its investments in 2030.[1] Development bank FMO has set as its objective for 2020 to double its impact and halve its footprint. Rabobank has defined a sustainable foodsystem as its objective. APG has committed to doubling its renewable energy investment within three years by 2017.

On the financial risk

7. Ecological and social imbalances are building up and pose a real and growing threat for destabilizing the global economy and hence its financiers. This is increasingly recognized, for instance by the current prudential investigation in this field by the Bank of England and by the G20 request to the Financial Stability Board to consider how central banks should assess climate-related risks to financial stability
8. In the Netherlands the investment organization of ABP, the Dutch pension fund for civil servants and teachers, has analysed the risk exposure of its investments stemming from stricter government measures to combat climate change.
9. Dutch banks are also increasingly integrating Environmental, Social and Governance (ESG) issues into their credit decisions and risk models, defining an ESG-risk appetite like ABN AMRO Bank and ING have done. Moving from excluding worst offenders to recognizing sustainability leaders.[2]
10. However, much is still to be learned in this process. First there is a data problem. Which companies and projects carry which risk? Carbon accounting is still in an early phase. Aggregated data across industries is needed. The recent announcement of the French Government of forthcoming legislation that would mandate carbon disclosure by major companies is seen by some as helpful in this regard.
11. Next, scenarios are needed that show how different social and environmental factors might impact all assets. At the moment environmental stress testing is mostly limited to the effect on the fossil fuel companies and not on how the wider economy is impacted.
12. This data is needed to convince both the risk modellers, credit commissions of financial institutions and the regulators to be more pro-active in this field. Only then can the full effect of ecological tensions on the financial risk be recognized fully and ESG-risks be translates into the pricing of loans and investments. Only then can frontrunners in the field of ESG be rewarded for their efforts and will the financial market become a true driving force for change. Currently however regulation like Solvency 2 and Basel 3 limits making this distinction between corporates and projects with a lower risk due to better ecological performance.

[1] See link and ASN Bank Carbon loss and profit methodology
[2] See for example ING's sustainability approach to lending

On the financial return

13. It is however not only through considerations of risk reduction that financial institutions should be aware of ESG-factors. The transition to a sustainable economy will shape the global economy in the decades to come. Understanding this change and being ahead of the rest on this offers great opportunities.
14. Banks feel this, as their customers increasingly ask them for new products that better fit the changing business landscape, for instance the new business models that come with the circular economy.[3]
15. Asset managers also increasingly find that sustainable investments offer a good return. Especially worthwhile is investing in companies that improve their ESG performance as this adds value. Investors can play an active role in this transformation through their engagement.
16. However, whereas the financial sector needs to adapt to the demand of frontrunners in the sustainability field, the practitioners of the circular economy also need to adapt in order to tap into the financial potential. Investors currently often struggle to fulfill their mandate in ESG-investments due to a lack of investable projects and companies. Needed are templates and standards for making existing real estate more energy efficient. In the Netherlands the Dutch Investment Institution (NLII), established in a joint effort of the government and private sector, is doing this.

On the values approach

17. However important it is to better capture the ESG risks and returns, this will not suffice. Fundamental values are, or cannot be, integrated in the financial models, or only to a limited extent. Take the example of the carbon bubble-risk. This can be mitigated by either reducing the investments in fossil fuels (and hence the risk of catastrophic climate change) or by lobbying against public policies aimed at reducing Green House Gas-emissions. From a (short term) risk perspective these might be the same, from a values perspective they are not.
18. If ESG is only taken into account as an investment or financial risk, you will not end up in a sustainable society. Many risks are not financially valued (loss of ecosystem services, poverty etc.) or are externalized to parts of society that cannot speak out (the poor, future generations). And often the moment for example climate change becomes a financial risk it is too late as the damage is irreversible. A pure risk approach thus falls short.
19. Therefore next to risk and return the financial sector needs to also implement a values approach. This has been recognized by the Dutch financial sector, for instance through being a driving force for the setting of global standards in this field, like the Equator principles, the UNPRI and the Principles for Sustainable Insurance. Recently the Dutch banking sector adopted its ‘societal statute’ in which the banks define their role in society as helping society to overcome the challenges in the field of climate change and health care. All Dutch bankers also pledge from this year onwards an oath promising to carefully balance the interests of all stakeholders of the bank: its employees, shareholders, clients and society at large.
20. Important is also to look at the intrinsic motivation of the people working in, and especially those leading, the financial institutions. Boards and regulators of financial institutions need

[3] ING, Rethinking finance in a circular economy, 2015

to ensure that there is enough expertise and motivation in the field of ESG at all levels of the financial institutions. ESG is not to be confined to a separate directorate. The Dutch central bank (DNB) has started a program on culture and behavior in financial institutions and pays more attention to this in their qualifications of potential board members.

21. A values approach also requires a more intensive dialogue with customers, both the ones saving and the companies that are financed or invested in. People need to be engaged and included in a meaningfully discussion. For this financial institutions need to be sufficiently transparent, also with regard to the non-financial impact of their activities.

<u>On the role of regulation and regulators</u>

22. Regulators play an important role in allowing and stimulating the financial sector to finance the transition to a sustainable economy. This also fits their mandate as failing to make this transition will lead to an unstable society and economy and hence unstable financial sector.[4]
23. A first step would be to bring into focus what unintended consequences of the post 2008 reform agenda might be hindering a more sustainable finance. We already mentioned the limited room within Solvency 2 and Basel 3 to differentiate risk weights and hence capital requirements based on ESG-factors. More long term, illiquid investments also get higher capital charges, and are thus discouraged by the new regulations.
24. Other regulations hindering sustainable finance are the use of short-term oriented models to evaluate the solvency of asset managers and the use of market wide benchmarks in this. This makes it hard to build a portfolio of companies that in the long run may be more stable and provide a higher return but that requires more spending on investments currently that are not valued as such by a myopic market. The still dominant belief in perfect markets and hence the value of spreading asset to reduce risk, in combination with the emphasis on cost reduction, push further towards passive investing. For small investors, like small pension funds, a ' green index' may be the most sensible way. However, more impactful ways of investing require a more active approach that may lead to more concentrated portfolios. Balancing a (much) lower environmental risk against a (little) higher concentration risk or a lower liquidity is difficult within the current supervisory framework.
25. Also, regulation meant to protect the financial consumer may be counterproductive, making it practically impossible for retail investors to participate in impact investing.[5] As a result they are stuck with the obligation to either invest their money in regular assets that expose them to higher ESG-risks. Or they may engage in peer-to-peer finance, like crowdfunding, where they are not advised by a financial professional, increasing their credit risk exposure.
26. Regulators indicate that these issues have been raised before, but that what is still lacking is a more detailed case description of how current regulation actually hinders sustainable finance. A step forward would be to collect clear cases where the tensions between sustainable banking and investing and the regulatory framework arise.
27. Regulators can also help by creating more transparency and by sharing best practices in the field of ESG in their supervisory task. Here a principle-based approach is to be preferred to a more rule based approach.

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[4] Schoenmaker, van Tilburg and Wijffels, What role for supervisors in addressing systemic environmental risk?, 2015

[5] Triodos bank, Impact investing for everyone, 2014

28. A specific noteworthy Dutch example is the Green Funds Scheme, a tax incentive scheme launched in 1995 by the Dutch government to encourage individual investors to put money into projects that benefit nature and the environment. It sets technical and financial conditions, but the main requirement is that these are new projects providing a significant and immediate environmental benefit. Generally these projects range from environmentally friendly greenhouses and wind turbines to organic farming and afforestation. Individuals who invest in a green fund receive a lower rate than the market interest rate (generally 1% lower), however this is compensated by the tax advantage. The Dutch Ministry of Housing, Spatial Planning and the Environment found, in a 2010 report, that in 2010 alone around a quarter of a million investors have put up seven billion euros, enabling six thousand green projects to be funded.[6]

<u>On the Dutch approach</u>

29. 'The train has left the station', the global financial sector is making the transition to a sustainable sector, emerging countries are adopting promising approaches.
30. The Netherlands as a country has a rich history of understanding the complex interrelationship between the environment, its economy and the wellbeing of its citizens. Being for a large part located below sea level, bordering the sea, the Dutch have always and successfully worked together to make and keep the land dry and save. Also the importance of social cohesion is long recognized in what is one of the most densely populated countries of the world.
31. The Dutch have developed a character of cooperation, and accompanying institutions ranging from several platforms for regular discussion amongst potential adversaries like employers and employees to international institutions for peace and justice like the International Court of Justice and the International Criminal Court.
32. This so-called '*poldermodel*' is also proving its worth in the sustainability transition. In 2013 more than 40 organisations agreed on a national accord on energy to which all major Dutch banks cooperate to remove obstacles in finance for investments in renewable energy and energy efficiency.
33. Currently the financial sector is discussing with government and other stakeholders a covenant/agreement in which they will detail how to work with ESG risks.
34. The Dutch EU-presidency in the first half of 2016 has the circular economy as one of its priorities. Bringing further the proposals in this field that the European Commission is expected to launch later this year.[7] Special attention could be given to the financing of the circular economy. Also linking this to the Commission's work in the field of Long term investing by e.g. building on what Dutch pension funds are doing and want to do more of by enhancing the enabling environment for investing more in solutions to sustainable development challenges.

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[6] *The green funds scheme – a success story in the making.* Ministry of Housing, Spatial Planning and the Environment, 2010.
[7] See http://ec.europa.eu/environment/circular-economy/index_en.htm

List of attendees May 26 Utrecht

Maria Anne van Dijk	ABN AMRO Bank *Senior Advisor Environmental, Social and Ethical Risk & Policy*
Hassan Outaklla	Autoriteit Financiële Markten *Strategy & Policy Officer*
Liesbeth van der Kruit	Achmea *Director Corporate Social Responsibility*
Neil Smith	Aegon *Senior Associate, Sustainability*
Claudia Kruse	APG *Managing Director, Head of Governance & Sustainability*
Piet Sprengers	ASN Bank *Head Sustainability*
Marco van Hengel	De Nederlandsche Bank *Senior policy advisor*
Aloys Wijngaards	De Nederlandsche Bank *Strategic Policy Advisor*
Dirk Schoenmaker	Duisenberg school of finance *Dean*
Leon Wijnands	ING *Global Head of Sustainability*
Esther Reilink	Ministry of Foreign Affairs, Netherlands *Senior Policy Advisor within the Inclusive Green Growth Department*
Martin Lok	Netherlands Ministry of Economic Affairs *Program Manager Natural Capital*
Saskia Dirkzwager-de Rijk	Ministry of Finance *Senior Policy Advisor*
Melle Bakker	Ministry of Finance *Policy Advisor*
Koert Ruiken	Ministry of Infrastructure and the Environment - Directorate Sustainability *Senior Policy Advisor / Economist*
Willemijn Verdegaal	MN Services *Advisor Responsible Investment & Governance*
Gert-Jan Sikking	PGGM *Managing Director Innovation Institutional Business*
Bas Ruter	Rabobank *Director of Sustainability*
Caroline van Leenders	Rijksdienst voor Ondernemend Nederland *Senior process manager sustainable transitions*
Herman Wijffels	Sustainable Finance Lab/Universiteit Utrecht *Chairman/Professor*
Rens van Tilburg	Sustainable Finance Lab *Director*
Elisa Achterberg	Sustainable Finance Lab/Circle Economy *Project Manager and Researcher*
Thomas Steiner	Triodos Bank *Director Corporate Identity*
James Vaccaro	Triodos Bank *Head of Strategy*
Simon Zadek	UNEP Inquiry: Design of a Sustainable Financial System *Co-director*