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Setting Sustainability Standards for the Financial System in Asia-Pacific

Climate change represents an enormous risk to the financial system. The financial system faces two different kinds of climate-related risks: physical risks, arising from damage to property, infrastructure and land; and transition risk, a result from exposure to industries not built around the economics of low-carbon emissions. Both risks run divergent to each other. This means, in case urgent and drastic measures to combat climate change are taken, transition risk will increase while, in case Governments and other stakeholders fail to combat climate change, physical risks will soar. Consequently, there is no scenario where both risks can be avoided and hence it is imperative that they are recognized within the financial system. The Asia-Pacific region lost more than $1.5 trillion due to disasters since 1970 (ESCAP, 2019a). This number is set to increase in the future, given the climate change-driven increased frequency and severity of disasters (physical risks).

At the same time, climate change also provides significant financing opportunities. An additional investment of $1.5 trillion is necessary to reach the UN's Sustainable Development Goals by 2030 (ESCAP, 2019b). Moreover, for the fulfillment of clean energy and climate action alone and just for developing countries in Asia-Pacific, average annual investments of $434 billion[1] are required until 2030 (ESCAP, 2019b). These sums cannot just be borne by public funding. The financial sector needs to take on the imperative role of funding a major part of these investments and hence to close the financing gap. For that, the financial sector needs to become green and sustainable.

Overview of Sustainability Standards

Climate change risks are a global issue, yet, regulations and standards are developed locally. The financial system is not a homogenous entity but consists of different actors who all need to be part of this standardization and cooperate with each other. However, data limitations, tight timeframes and uncertainty about methodologies have slowed down individual efforts (IIF, 2020). Actions by all stakeholders need to be in accordance with not just climate change but also the broader sustainability aspects on environment, social and governance depicted in Figure 1.

The most promising way of greening the financial system is by bringing system-wide common understanding of what sustainable or 'green' means. In other words, definitions, measurements and reporting needs to be standardized. Sustainability standards, if communicated correctly to the society, can inform individual investors about the sustainability aspect of investment prospects. From the consumer perspective, standards need to be harmonized to increase understanding of sustainability and make Greenwashing more difficult and easier to detect. However, even if financial institutions are willing to follow sustainable standards, growing confusion and uncertainty about what and how to implement is slowing the progress (IIF, 2020).

Figure 1. Morgan Stanley Composite Index: Environment, social and governance hierarchy

Source: Morgan Stanley Composite Index, available at www.msci.com

Induced by the region's unprecedented need for investments that must include the costs of climate change adaption and mitigation (ADB, 2017), the Asia-Pacific region has developed a multitude of standards for a green financial system (IOSCO, 2019). However, these standards can differ widely between countries. As a practical example of the described fragmentation, consider climate-related scenario analysis, which is just a part of overall climate risk frameworks. The Bank of England bases its analysis on four scenarios while a multinational forum of policymakers (*Central Banks and Supervisors Network for Greening the Financial System*-NGFS) recommends a three-scenario-approach (IIF, 2020). *Singapore* is focusing on insurers while *Denmark* argues that credit institutions should be the focus and *Australia* is conducting exercises for both (IIF, 2020).

The most common method to raise sustainable debt finance is to issue bonds. Government agencies in *China*, the world's second largest green bond market (CBI, CCDC, 2018), released a guidance for supporting green bond development in 2017 and followed up with a guideline towards a green financial system in the same year. China has already realized its domestic fragmentation of standards and two relevant government agencies[2] released guidelines on green bond certification in an effort to align existing standards. Going forward, the country plans to implement mandatory environmental disclosure mechanisms for financial sector.

India also issued green bonds guidelines in 2017. The Financial Services Authority of *Indonesia* also issued policies regarding green bonds and blended finance schemes in 2017, including a standardized sustainability report with an action plan regarding the implementation of financial sustainability initiatives. Since then, 80 per cent of Indonesian commercial banks have submitted such action plans.[3] Many other nations in the region have also implemented their own green finance standards.

In terms of regional standards and as a first step towards harmonization of standards, **ASEAN has published a guide on green financial instruments in 2019 (CBI, 2019).** Leading the way in terms of multinational standard setting is the European Union (EU) with its *EU Taxonomy (European Commission, 2020),* creating the first cross-market legal obligation across all EU member states.

Current Issues

The process of putting into place **new sustainability standards *begins with regulatory agencies*** reaching a **decision on which standard to adopt**, then putting this standard into regulations and thereafter taking steps to ensure that all relevant stakeholders act in accordance with the new regulation. Also, standards need to be harmonized with other countries. While this process appears to be sequential at first glance, it is not. Harmonization efforts take place throughout the whole process. Monitoring regulations in practice leads to necessary improvements of existing regulation or the development of completely new pieces of regulation.

The key issue is the fragmentation of standards. Two thirds of the participants of a recent survey (IIF, EBF, 2020) said they are concerned about the fragmented green market regulations. Standards are not standards if there is no market-wide acceptance for them (IPCSA, 2020). Central banks and other policymakers themselves are concerned about comparability and consistency of their policies (IIF, EBF, 2020). The current process looks very much like an every-country-for-itself procedure which has several crucial weaknesses.

First, the whole process is very slow as this an entirely new subsection of regulation and it will naturally take longer when every regulatory agency accumulates knowledge separately. This is especially troubling because climate change and its risks are an urgent issue where no time should be wasted unnecessarily.

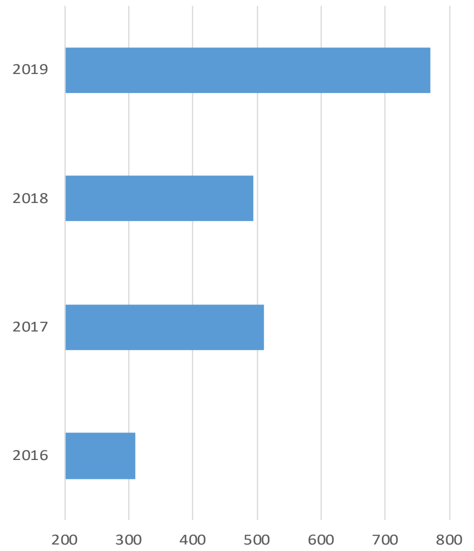
Second, the quality and effectiveness of resulting standards will also be impaired (IIF, 2020). A competing approach to greening the financial markets could lead to geographies which are less strictly regulated then others. Similar to tax havens, this could hinder the effectiveness of all global efforts to greening the financial system as “brown” financial activity can then shift towards these jurisdictions.

Third, internalization of standards is costly. The cost of implementation would be a key issue for local, small and medium enterprises (SMEs), and regional companies. Even for multinational corporations the heterogeneity of standards has become an unnecessary and avoidable hurdle.

Fourth, a patchwork solution and a lack of standards in general provide unnecessary opportunities for Greenwashing, given consumer’s inability to decipher the methodology behind a standard (ESCAP, 2020). Greenwashing is the process when companies use misleading labels and advertising material to create a self-image of environmental responsibility without becoming more responsible. China has implemented stricter penalties as a step towards combatting falsified or greenwashed environmental information (SSE Initiative, 2018).

Figure 2 depicts the number of new sustainable finance regulatory developments from 2016 to 2019 worldwide. While it is heartening to see the tremendous effort put into the development of such numerous regulations, **the sheer number of new developments fuel the increasing and real danger of further fragmentation.**

Figure 2 Number of sustainable financial policy developments



Source: ECOFACT database, visualization adapted from Institute of International Finance (2020)

Greening the financial system

Other than the government, the financial system comprises the financial sector, businesses and investors. All can contribute their accumulated knowledge to assist policymakers to make market-ready standards on reporting and disclosure of climate risks. One such way for doing so is to join Taskforce on climate-related Financial Disclosure (TCFD), the major international standard for disclosing climate-related risks. TCFD has seen widespread support and ongoing development within the financial system. As of February 2020, there are 930 signatories of TCFD, of those 396 are from the Asia-Pacific region. Within the region, Japan leads the way with 245 signatories. TCFD itself is still a work in progress. A regularly cited issue with TCFD is insufficient disclosure of information limiting ESG reporting on key performance indicators.

Institutional investors like asset managers and pension funds need to create the demand for products compliant with a green financial market. By doing so they commercially incentivize other financial companies and their products to become part of the green financial system. The leading standard for green financial system-compliant investing is the *UN Principles for Responsible Investment (UNPRI).* Its six principles offer actions for incorporating ESG factors into investment decisions. The UNPRI currently has 2,300 signatories but only 15 per cent of those come from the Asia-Pacific region. The provided classification is only a model and the presented standards are incomplete. Interests as well as possible impacts on greening the financial system can differ drastically between actors within each group.

Individual investors can influence the progress towards a green financial system by demanding more information on sustainable investments. It is imperative for them to know which products actually are sustainable, thus putting more pressure to adopt suitable standards urgently.

Recommendation for financial regulators

Financial regulatory agencies are the key player in setting standards, harmonization and ultimately enforcement. For many developing Asia-Pacific countries, a *starting point* could be to join international forums to exchange knowledge about sustainability standards. A notable example is the Central Banks and Supervisors Network for Greening the Financial System (NGFS), established with the explicit goal of sharing learnings on green financial system policies. The network currently has 55 members and 13 of those are from the Asia-Pacific region.

Next, regulators can mainstream standardization of reporting and disclosure. One approach is to adapt the TCFD Implementation Guideline and align it with domestic reporting and disclosure regulations. This will require an allocation of resources and the creation of a dedicated unit to integrate TCFD into mandatory regulations. The other approach would be to nudge financial sector and businesses to voluntarily follow and implement the TCFD Implementation Guidelines and United Nation's PRI on their own initiative. A dedicated unit can be created in this case as well to help each business integrate or break down areas of TCFDs and United Nation's PRI relevance to their own business models.

Endnotes

1. This estimate includes $12 billion in universal access to electricity and clean cooking solutions, $242 billion in renewable energy and $180 billion in energy efficiency.

2. Namely, these were the People's Bank of China and China Securities Regulatory Commission.

3.Financial Services Authority of Indonesia's presentation to the UN ESCAP on October 18th, 2019, 'Indonesia's Financial Sector: Contributing to Sustainable Finance'

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. The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. The issue was prepared by Jyoti Bisbey supported by Julian Thiel, Sahil Uddin, Chong Nam Yu and Chris Qihan Zhou (interns) under the guidance of Sweta Saxena (Macroeconomic Policy and Financing for Development Division). For further information, please contact Hamza Ali Malik, Director, Macroeconomic Policy and Financing for Development Division, ESCAP (escap-mpdd@un.org).

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