

Implications of the COVID-19 Pandemic for Global Sustainable Finance:

AN INITIAL FRAMEWORK FOR RESPONSE STRATEGIES

PRODUCED FOR THE FC4S MEMBERSHIP



Climate-KIC

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International Network of Financial Centres for Sustainability

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More information on FC4S is at: www.fc4s.org or from: Mr. Stephen Nolan, Managing Director stephen.nolan@un.org.

The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme (UNEP) to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it published the first edition of 'The Financial System We Need' in October 2015, with the second edition launched in October 2016 and its final report launched in 2018. The Inquiry has worked in 20 countries and produced a wide array of briefings and reports on sustainable finance.

More information on UNEP Inquiry is at: www.unepinquiry.org or from: Ms. Mahenau Agha, Director mahenau.gha@un.org.

UNDP Finance Sector Hub

UNDP's Finance Sector Hub (FSH) is a finance and innovation platform that draws on a critical mass of UNDP expertise, initiatives, and partnerships to support the mobilization and leveraging of resources for the SDGs and lead the implementation of the new UNDP private sector strategy and other initiatives which fully supports the implementation of the Strategic Plan and supports governments to align private sector activities and financial investments with the 2030 Agenda. The Hub is an integral part of both the Bureau for Policy and Programme Support (BPPS) and the Bureau of External Relations and Advocacy (BERA), as part of the Global Policy Network.

More information on the UNDP FSH is at: www.undpfsh.org or from: Mr. Marcos Neto, Director marcos.neto@undp.org.

Climate-KIC

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About this report

This document is an initial effort to map out key impacts of the COVID-19 pandemic ('the pandemic') on the global sustainable agenda, applying publicly available information. The purpose of this exercise is to set out a simple framework for analysis, using current data as examples, which can help inspire thinking by different communities of actors on response strategies. This document was written by Jeremy McDaniels of the FC4S Secretariat, with the support of other UNEP colleagues (Mahenau Agha, Mark Halle, Olivier Lavagne d'Ortigue, Marcos Mancini, Stephen Nolan and Sarah Zaidi) and Marcos Neto (UNDP).

Please send us any information that you think might strengthen the paper and any ideas or innovations you think might be of interest to other stakeholders.

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WORKING PAPER

1. Introduction

Not for decades has the financial system had to deal with a crisis of the magnitude of the COVID-19 pandemic. In a few short weeks, the financial system as we have known it has been turned on its head and has now to deal with issues – present and future – that are quite literally life-or-death challenges. There is little doubt that the pandemic will be considered one of the most significant global events since World War II, which shaped our current global economic and financial order. Now, the future of our financial system is uncertain – but it is increasingly clear it will not go back to its pre-crisis form.

Clearly all of us and our governments must give priority to addressing the immediate health issues, as well as the impact on the poor and vulnerable of the shutting down of our economies. But as we do that, we should also be thinking how we can rebuild when the crisis fades and generalized economic activity once more becomes possible. Both the disruption we are living today, and the necessary delays in initiating large-scale economic recovery programmes, must not be seen simply as a disaster – but as an opportunity to rethink the structure of the economy, and to plan for how the economy can be aligned with a resilient, low-carbon future.

Pandemics and climate change both have huge socio-economic consequences triggered by physical shocks – setting them apart from previous financial crises that are generally a result of the loss of confidence and are triggered from within the financial system itself.¹ Physical shocks can only be solved by addressing the root causes whereas financial shocks can often be dealt with by restoring confidence. Both are examples of non-linear risks where socio-economic impacts grow non-linearly once thresholds are breached. Solutions to both pandemics and climate change require strong global cooperation across the public and private sector.

In this dynamic context, we have developed this paper to support thinking on how to respond to the pandemic from a sustainable finance perspective. Specifically, this paper has two objectives:

- The first is to set out what we know about the ways in which the many different components of our sustainable financial system – market actors, policymakers, regulators, and international institutions – are thinking, planning and reacting to the pandemic, with a focus on implications for sustainable finance markets. As such, it is a work in progress, and will be updated and refined over time as new information and new ideas come to our attention.
- The second objective is to set out a framework for assessing what levers may exist to strengthen the role of the financial system in supporting a low-carbon recovery, and the prospective roles for different communities of actors.

This paper is organized into four sections (Financial and Capital Markets; Policy Action; Regulation and Supervision; and International Networks) covering recent developments, and a high-level outlook towards a post-crisis phase. A final section seeks to inspire reflection by different stakeholder groups.

This paper is not intended to be comprehensive across the wide range of sustainability-related implications of the pandemic and is focused on developments within the financial system. For instance, it does not attempt to forecast how macroeconomic trends may impact the trajectory of the low-carbon transition. Rather, this paper is a preparatory effort to inspire thinking by different communities of actors on response strategies over the coming months and help identify where collaboration will be required.

2. Financial and Capital Markets: Sustainable Finance Performance & Market Practices

The near global lockdown in response to the COVID-19 pandemic represents an unprecedented disruption of economies and financial systems. In many major economies, as demand and supply shocks in labour and energy markets compound, entire industries are shutting down, unemployment records are being shattered, and non-essential household spending is significantly contracting. Already, financial market disruptions are on par with the greatest stock market crashes of the 20th century – with roughly US\$26 trillion wiped off of global stock market valuation.

As financial market turmoil has enveloped global markets, there has been a flurry of analysis on the impacts and implications for sustainable finance. In these early days, the focus has been on equity and debt markets, including the performance of sustainability-related thematic investment products. This section provides an overview of key developments and debates in recent weeks, focusing on market behaviour and strategic responses of firms.

2.1. Equities: performance of Environment, Social and Governance (ESG) Funds and Indexes

Evidence shows that ESG-related investments (both funds and indexes) have mildly outperformed benchmarks in the crisis. However, this performance delta is far from universal across all sustainability-related financial instruments, and is contingent on asset allocation, fund structures, and diversification. Bloomberg data suggests that Exchange Traded Funds (ETFs) with a lower-carbon tilt slightly outperformed the S&P 500, while clean energy indexes fell (Figure 1).

FIGURE 1

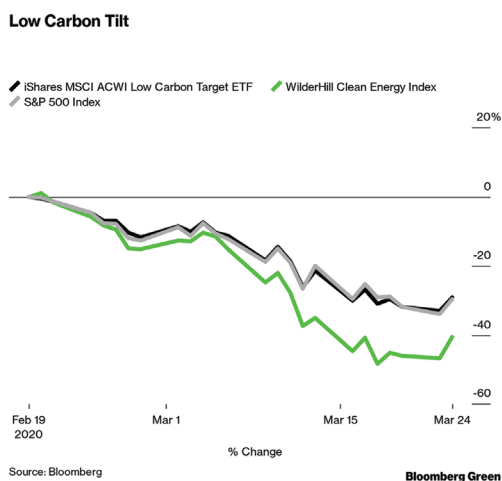
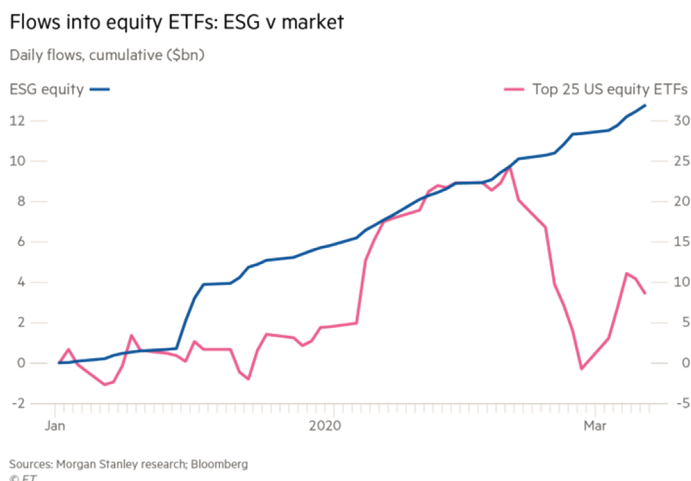


FIGURE 2



Other analysis conducted by Bloomberg suggests that an ‘average ESG fund’ declined by 12.2% YTD 2020, almost half the decline of the S&P 500 over the same period.²

- MSCI analysis suggests that an ‘ESG leaders index’ has experienced continued outperformance during pandemic-related declines and volatility.³
- Morningstar analysis of sustainable ETFs/index funds illustrates small outperformance delta compared to mainstream tracker funds, in analysis YTD to mid-March.⁴
- HSBC analysis has found that ‘climate-focused’ stocks outperformed others by 7.6% from December and by 3% since February, while stocks with ESG scores beat others by about 7% for both periods.⁵
- BofA Securities analysis has found that the top 20% of ESG ranked stocks outperformed mainstream US market benchmarks – and that this outperformance persisted even when adjusting for ‘sector-bias’ effects (e.g. weighting of ESG stocks towards healthcare/consumer staples).⁶

As many of these funds are quite new, this is the first test of ESG funds in a bear market. While it is premature to make strong conclusions on the resilience of ESG funds in a highly volatile environment, initial indications suggest that the ‘defensive’ aspects of diversified ESG funds (including exclusions of high LCOE fossil fuels) have contributed to slight outperformance.

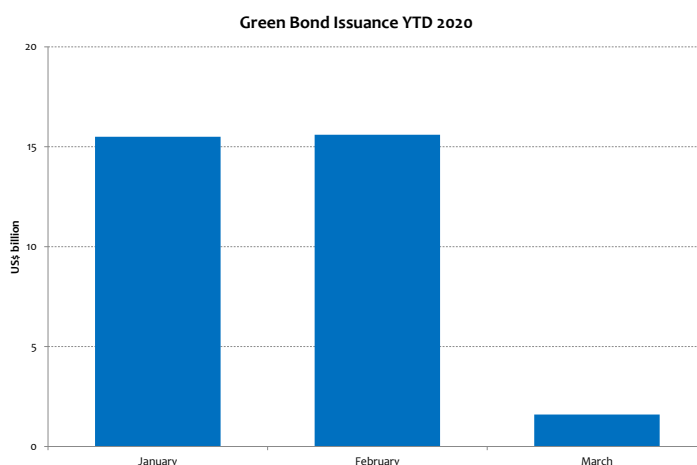
Investor confidence in ESG funds appears to remain strong (Figure 2). Inflows into ESG funds have continued steadily during Jan-March 2020 at roughly US\$4 billion per month, while the inflows into the top US equity ETFs exhibited marked volatility (and a precipitous drop) over the same period.

2.2. Debt: green bonds, sustainability-linked loans, project finance

Sustainable debt markets appear to show a similar story of (slight) outperformance and continued investor confidence. However, the impacts of the pandemic on sustainable debt (e.g. green and sustainability-linked bonds and loans) are more difficult to evaluate at this stage, considering the lag time between arrangement, issuance, and trading in secondary markets.

Issuance of green bonds has dropped significantly. While March 2020 saw issuance of some notable green bonds – including Prudential Financial, a first from a US Life insurer⁷ – data from the Climate Bonds Initiative suggests that monthly issuance has declined by approximately 90% from February (Figure 3).

FIGURE 3

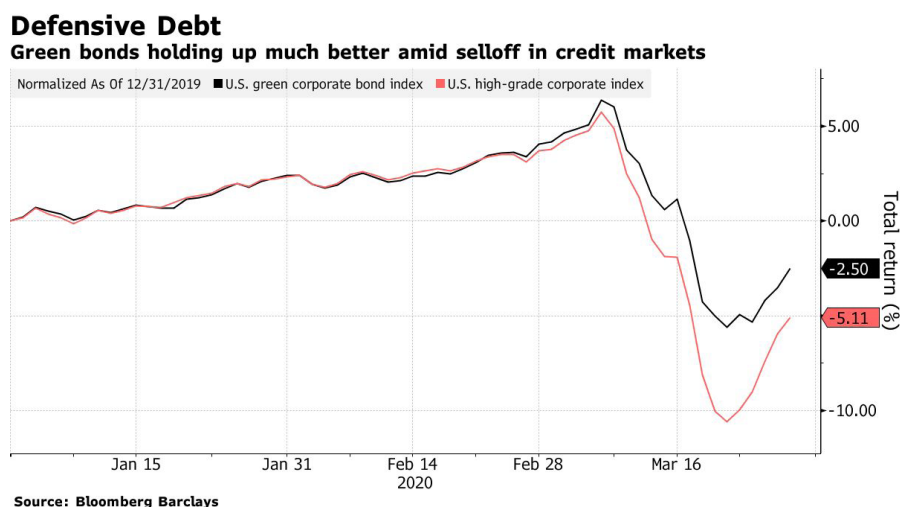


Source: Climate Bonds Initiative Green Bond Market Tracker, accessed 30 March 2020



However, green bonds are retaining value better than mainstream corporate debt. While issuance has been ‘put on pause’, data from Bloomberg/Barclays (Figure 4) suggests outperformance of the US Green Bond Index of 261 bps in comparison to the US high-grade corporate index.

FIGURE 4



Source: Bloomberg and Barclays, via MSCI

Contractions in credit markets are also affecting other types of green debt. In China – the world’s largest green debt market – there is already evidence that demand for green finance has significantly decreased. Green loans – an increasing popular instrument in China for investments in enhancing energy and resource efficiency of industrial production – have been absent from the market, spare one deal signed in the first quarter.⁸ This is a marked decline from 2019’s eight-year high of US\$1.8 billion, a five-fold increase from 2017. As China’s recovery advances, the resurgence of green instruments (in comparison to mainstream funding vehicles) will be a bellwether for other markets.

Analysts have expressed a range of views on how COVID-19 is likely to affect sustainable debt markets. A review of recent commentary suggests a wide range of potential outcomes for different classes of issuers, stemming from the size and direction of stimulus efforts, policy changes relevant to use-of-proceeds (e.g. renewable energy generation, energy efficiency retrofits), and the divergence in COVID-19 impacts across developed and emerging economies.

- The increasing focus on ESG in emerging markets in 2019 has been predicted to spur growth in sustainable debt issuance in 2020 – but the fallout from the coronavirus outbreak has dampened near-term prospects.⁹
- Sovereigns, Supnationals and Agencies (SSA) issuers may seek to scale up issuance of thematic bonds, including green bonds, as a channel to raise capital for stimulus efforts.¹⁰
- Arrangement and syndication seem to be constrained, as demand for cash has reduced uptake of syndicated debt in secondary markets. This may affect signing of new green loans and capacity for new types of green securitization.

Pipelines of new greenfield low-carbon projects (e.g. renewable energy) are likely to be significantly reduced for the foreseeable future, both in developed and emerging markets. The complexity of renewable energy project finance is already difficult to orchestrate and is likely to be ‘all but impossible’ until pandemic-related economic paralysis loosens.¹¹ The length of time that project financing is put on hold will be crucial for future development of wind and solar industries, especially in nascent markets in emerging economies.

Over the longer term, green debt may outperform other types of debt instruments intended to support capex investments.¹² Firms are currently turning to working capital facilities to support liquidity and manage OPEX in response to demand shocks and

are for the most part suspending CAPEX decisions that were not under way before the pandemic began. Future demand for sustainable debt will be shaped by the loosening or strengthening of environmental policy and regulation in the post-crisis phase, when investment decision-making will ramp up.

2.3. Other markets and asset classes

The implications of the pandemic for other dimensions of sustainable finance (markets, assets, services, etc.) are not well understood at this early stage. Initial reactions include:

Insurance: Certain segments of insurance markets are beginning to feel the effects of the pandemic, including trade credit insurance and business interruption insurance, which will be contingent on evolving legal precedent regarding pandemic-related exclusions. While it is unclear how exactly the pandemic may influence demand for ‘sustainable insurance’ products, such as coverage for climate-related disasters, the longer-term impacts of the pandemic on resilience investments (and more broadly, supply chain risk management) are likely to create opportunities for the insurance sector. There is apprehension within the reinsurance and broking community that a medium-intensity climate-related event – for instance, flooding in the Midwest US – could have disastrous consequences, as public agencies charged with disaster response have allocated all resources to responding to the pandemic.¹³ Under a scenario of a lengthy containment period, climate-related natural disasters are likely to lead to significantly greater insured and uninsured losses in pandemic-affected areas – including in especially climate-vulnerable countries.

Ratings: Over coming months, the influence of ESG factors on credit quality will become more apparent, as downgrades ripple throughout the economy and the financial system. The pandemic-induced halt to the economy, coupled with falling oil prices and ‘extreme volatility in capital markets’, is expected to result in a more than 10% increase in the default rate on non-financial corporates in the US and ‘to high single digits in Europe’ in the coming months, according to S&P Global Ratings.¹⁴ Already, S&P has taken 330 ratings actions on corporate borrowers in response to the pandemic.¹⁵ The impacts of downgrades of sovereign ratings, including in emerging markets, will further raise the cost of capital for these countries – where public resources to fund green investments, or support economic transition away from fossil fuels, will already be under pressure.

2.4. Outlook for markets

Drive for ESG alpha – surge of focus on social issues. ESG factors have proven important for many investors seeking to assess the impacts of the pandemic on corporates. Prior to the pandemic, analysts have suggested that stronger ESG performance is likely to lead to lower declines during market downturns, due to lower incidence of controversies, greater customer loyalty, higher employee satisfaction and retention, and more conservative financial planning.¹⁶ Continued analysis of ESG performance during the crisis – examining how environmental (e.g. energy demand, pollution), social (e.g. labour conditions), and governance factors (e.g. balance sheet stress) affect the competitive position of firms in an extreme scenario – can help inform longer-term views on resilience of business strategies, and impacts of relief and recovery measures.

Companies’ treatment of their employees has emerged as a front-page issue in many of the world’s largest markets. As widespread unemployment mounts, the lack of health benefits for employees (e.g. paid sick leave) is emerging as a key responsible investment issue (see Box 1). While it is too early to tell what the long-term impacts of this increased focus may be, there is potential for a major ‘repricing’ of social issues in ESG ratings. Recent analysis by MIT found that in a dataset of five ESG raters, correlations between scores on 823 companies were on average 0.61. Going forward, this may motivate efforts to strengthen the coherence of ESG ratings information. Widespread investor focus on employee treatment could also influence policy responses, for instance efforts to clarify definitions, develop taxonomies, and implement investment product labels.



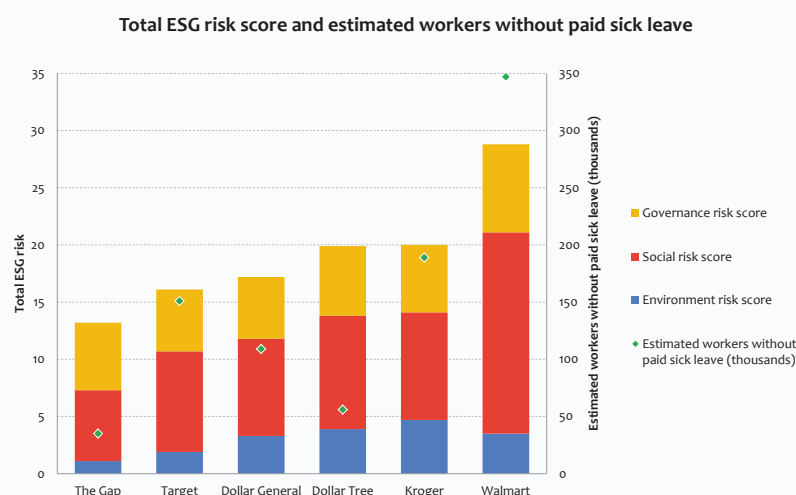
Fossil Fuel Stranding v2.0. While for certain sectors environmental dimensions of corporate ESG performance may decrease in significance in comparison in social issues, sectors with high environmental risk exposures (e.g. fossil fuels) are likely to face increasing environmental scrutiny. As the economic impacts of the pandemic lockdown filter through the economy, the reduction in oil demand will contribute to downward price pressure. Impacts in the financial sector are already arising, primarily through credit markets. JP Morgan, one of the world's largest fossil fuel financiers with oil and gas exposures of US\$41.6 billion of oil and gas exposures in 2019, saw its stock decline by more than 12% (as of 16 March).¹⁷ Due to diversification effects, and overall size, it would appear that large global banks are more insulated to price effects than smaller firms with national or regional exposures. The Bank of Oklahoma (BOK), which had US\$4 billion of outstanding energy loans (28% of its total commercial portfolio) concentrated in the US shale sector, has experienced a drop of 22% (as of 16 March).¹⁸

Shareholder resolutions and litigation. Securities class action suits stemming from COVID-19 have already been filed against cruise lines (alleging false statements regarding the risk of the pandemic) and pharmaceutical companies (alleging false claims pertaining to vaccines).¹⁹ While these examples are not immediately relevant to climate or sustainability issues, they offer a view into how financial market participants may react to future market disruptions or large-scale mortality events, many of which (including future pandemics) could have climate change or biodiversity loss as a root cause.

BOX 1. EMPLOYEE HEALTH BENEFITS AS A RESPONSIBLE INVESTMENT CONCERN

Corporate responses to the pandemic – including in the US,²⁰ now the global epicentre of the outbreak – are illustrating how employee protocols pertaining to sick leave (and other health benefits) may lead to significantly heightened exposure to coronavirus, ultimately resulting in higher mortality and greater economic damage. A comparison of retail companies in the US (Figure 5) reveals that the companies with a higher relative total ESG risk score (Sustainalytics ESG risk ratings) may have a larger number of estimated workers without paid sick leave. The companies illustrated in Figure 5 did not have paid sick leave policies in place when the pandemic outbreak occurred in the US, and since then several companies have changed their policies.

FIGURE 5



- **Walmart and Target:** have altered their sick leave policies and time-off, and offered extended leave policies to coronavirus-affected employees.²¹
- **Amazon:** initially received criticism over its public statements regarding unpaid time off and 'donation' of unused sick leave pertaining to the pandemic.^{22,23} It has since updated its policy to providing 'up to two weeks of paid sick leave to all employees'.²⁴
- **Facebook:** was dropped from the S&P 500 ESG index last year but has established a US\$100 million grant programme to support small businesses hit by the coronavirus.²⁵
- **Google:** Initially, its extended workforce of 135,000 (e.g. temporary workers and contractors) were not allowed to work from home while Google's 'employees' were asked to work from home due to the coronavirus, revealing a divide between full-time employees and contractors.²⁶

Shift to disclosure of more granular and quantitative ESG and SDG-related information. Currently, a significant amount of the ESG disclosure universe is relying on qualitative information, including ‘aspirational’ commitments which set out time-bound goals. While such measures will remain important as data pertaining to environmental impacts and performance stays scarce, the pandemic is likely to motivate a shift in the ESG data universe. Faced with volatility and widespread exposure of unknown vulnerabilities, investors may look to ‘harder’ indicators of sustainability-related risks, including supply chain vulnerabilities, risks to business interruption, and clearly articulated contingency plans for shock events. For instance, optionality and flexibility in production – including the current trend of adapting production to deliver medical personal protective equipment (PPE) – is likely to be increasingly important for firms’ competitive positions.

Multiple efforts are under way to strengthen harmonization of ESG disclosure standards – including the Corporate Reporting Dialogue (seeking to harmonize existing frameworks for ESG-related information), and the World Economic Forum International Business Council (IBC) Common Metrics project (currently under consultation). Mainstream financial sector associations, such as the Institute of International Finance (IIF), are engaged in efforts to harmonize existing frameworks and engage accounting standards entities (e.g. International Financial Reporting Standards Foundation). Within the United Nations system, UNDP’s Practice Assurance Standards for SDG Impact set a framework for integrating impacts on SDGs into business and investment decision-making.²⁷ The challenge will now be to ensure that these efforts deliver outcomes that respond to the changing needs and priorities of investors with respect to ESG data and disclosure – as well as rapidly move towards convergence.



3.

Policy Action: Green Stimulus

Emergency economic support packages (considered here as ‘first-round’ relief measures) are rapidly implemented across the world. A detailed summary of such stimulus measures is available from the International Monetary Fund (IMF). Table 1 below summarizes the three main areas in which governments are taking action, instruments (‘levers’) available, and examples of interventions.

TABLE 1

AREA	INSTRUMENT	EXAMPLE OF INTERVENTION
Monetary and Macrofinancial	Interest rates	Lowering interest rates
	Reserve requirements	Lowering reserve requirement ratios
	Liquidity provision	Provision of new credit facilities
	Asset purchasing	Government and mortgage debt Corporate debt
Fiscal	Public emergency spending	Funding for health equipment, containment measures, etc.
	Direct support to citizens and small and medium-sized enterprises (SMEs)	Cash payments to citizens Subsidization of wages Concessional loans to SMEs
	Relief measures	Delays in filing deadlines Constraints on new requirements
	Corporate bailouts	Loan guarantees Equity holdings
Currency	Foreign exchange controls	Opening of swap lines

There is virtually no evidence of consideration of sustainability priorities in first-round measures passed to end-March 2020. On the basis of analysis of IMF data, it appears that only one country – Lithuania – has introduced specific climate-related measures as a component of ‘first round’ efforts, in the form of co-financing for climate-related investment projects.²⁸ In the US, propositions to introduce climate-related provisions in emergency stimulus packages – for instance, the introduction of emission limits for airlines receiving bailout funding – were ultimately unsuccessful; however, negotiations pertaining to such propositions influenced the inclusion of other measures to support fossil-fuel industries. Throughout April 2020, there has been a few instances of governments attaching emissions reductions conditions to state aid relief for high-carbon sectors – notably in France and Austria.

Over the next three to six months, successive stimulus efforts will offer new opportunities to channel capital to the low-carbon transition. In jurisdictions with binding emissions reductions commitments, such as the EU, the legal foundation and political environment for crafting a green stimulus is stronger. The European Commission (EC) has indicated that it remains committed to the delivery of the European Green Deal (priced at more than US\$1 trillion), which aims to eliminate the EU's carbon footprint by 2050 and create a 'green stimulus', despite member states protesting about its cost when dealing with the pandemic.²⁹ In a statement released 26 March, the EC noted that it will 'start to prepare the measures necessary to get back to a normal functioning of our societies and economies and to sustainable growth, integrating inter alia the green transition and the digital transformation'.

Debate on the appropriateness of 'green stimulus', and optimal instruments, is likely to evolve in the coming months – with a major focus on monetary policy operations (including quantitative easing). Over the course of 2019, a significant amount of academic research focused on options for green monetary policy. However, few actual steps have been taken to integrate sustainability priorities into monetary policy decision-making, with three key factors as constraints:

- **Inconsistent definitions of 'green':** 2019 saw a rapid proliferation of efforts to develop taxonomies or classification systems to support coherence in sustainable finance, at the sector level within the real economy (e.g. EU, China), as well as at financial product level. Efforts to bring coherence to taxonomies (including through entities like the International Platform on Sustainable Finance) may be constrained throughout 2020.
- **No consistent evidence of risk differential between green and brown assets:** While analysis of NPL ratios of green loans in China has found indications of outperformance compared to mainstream credit, similar studies (e.g. examining European markets) have not yielded similarly conclusive results.
- **Inconsistent mandates:** Central banks have divergent mandates and tools at their disposal, which may enable or constrain capacity to consider sustainability priorities. While entities such as the NGFS have contributed to a consensus on the relevance of climate risk issues to central bank mandates, there are significant differences in the potential for action between institutions.

This may change, however, as financial reactions to the pandemic strengthens the data on sustainable finance risk and opportunity. In recent weeks, energy and commodities markets have been exposed to a real-life 'stress test' – where high-carbon sectors such as oil have been doubly impacted by supply and demand shocks.³⁰ A potential silver lining of the economic turmoil stemming from the pandemic is likely to generate new data insights on green vs. brown performance, especially with respect to central bank balance sheets (following 'greening' actions taken in 2019).³¹

Capital raising to fund stimulus will need to take many forms – and green securities can play an important role. Governments can issue sovereign green bonds and other sustainability-related securities to fund stimulus efforts. Several countries have indicated plans to issue green bonds over the course of 2020 – Germany's debt agency has confirmed that its plans for green issuance have not been deterred by the pandemic.³²

BOX 2. SOVEREIGN DEBT STRUCTURES APPLICABLE FOR GREEN STIMULUS CAPITAL RAISING

- Standard green bonds: green bond with use of proceeds clearly earmarked for green investments.
- Sustainability-linked bonds: pandemic-related thematic 'social' bonds, focused on supporting social infrastructure such as healthcare.
- Twinning/hybrid issuance: green bond with the same maturity and coupon as its conventional peer and replacing part of the conventional bond's auction volume, with flexibility to switch between the bonds for liquidity benefits.
- Green certificates: attaching a green certificate to a standard government bond, as a pledge for equivalent green spending in the absence of specifically earmarking funds for green projects.



3.1. Outlook for policy

Over the long term, a successful recovery will be contingent on a clear decarbonization pathway, with immediate investments in resilience. Indicators of alignment between recovery efforts and a low-carbon transition may be varied, and could include:

- Aligning long-term growth strategies and public investment with the Sustainable Development Goals (SDGs) or net-zero objectives (e.g. EU Green New Deal, Republic of Korea's Net Zero strategy)³³
- Using public funds to hire major workforce to deliver investments in low-carbon infrastructure, resilience, etc.
- Directly supporting emerging low-carbon industries facing high costs (e.g. heavy industries) and tackling barriers for implementation/penetration of low-cost technologies (e.g. wind/solar installation, grids, etc.)
- Loan guarantees and risk-sharing instruments to support the growth of innovative technologies
- Developing specific intervention funds targeted at SMEs are focused on green projects
- Taking equity holdings in high-carbon sectors to help shape transition pathways, thereby creating markets for transition-linked financial products
- Combining stimulus funding with revenues from pollution taxation structures to buy out high-carbon assets as a way to accelerate fossil fuel phase out
- Implementing major reforms to public welfare structures, in order to strengthen social cohesion

Implementation structures will need to consider (potentially) permanent changes in social organization and modes of working. For instance, a durable shift towards remote (or home-based) work in certain sectors could serve as the basis for a coherent suite of actions to green supply chains, transportation and communications infrastructure:

- Consumer goods, restaurants, hospitality receive support to move to remote commerce models
- Policy action to stimulate demand for electric vehicles through requirements on delivery companies³⁴
- New requirements on tech companies for greening of Internet networks, data centres, and other communications infrastructure
- Reforms in energy market design to further monetize flexibility



4.

Regulation and Supervision: Financial Stability and Stress Testing

Within the spectrum of relief actions taken by central banks and regulators, financial system regulation and supervision is of primary importance. Regulators are using a range of instruments available to promote financial stability. While it is beyond the scope of this paper to review all such measures, several key trends may be of relevance to sustainable finance objectives:

- There is potential for a short-term relaxation of requirements relevant to maintenance of financial stability, in response to significant losses/volatility due to extraordinary conditions. Within the US, the Commodity Futures Trading Commission has delayed the imposing requirements on a bank to be registered as a Major Swap Participant (leading to increased oversight and reporting burden) due to financial shocks stemming from losses on oil market swaps.
- The timeline for regulatory processes may be delayed. Analysts have suggested that consultations on regulatory reforms, the implementation of new requirements, and other exercises requiring data inputs from firms (e.g. exploratory stress testing) may be put on hold until the crisis abates.

4.1. Outlook for regulation and supervision

Financial supervisors are likely to strengthen focus on long-term risks with exponential characteristics – potentially leading to a more granular assessment of climate risks. Supervision and stability monitoring exercises – including stress tests regimes – do not generally consider pandemic events. A notable exception is the insurance sector, where pandemics are considered in jurisdictions with large life, non-life, and reinsurance sectors (such as the EU).

Regulators will have new opportunities to strengthen prudential scrutiny of climate risks in a post-crisis phase, as regulatory reforms take shape. As markets stabilize, new data on the risk performance of financial assets during the crisis period may enable consideration of a wider range of interventions to control for climate-related risks – for instance, a ‘brown-penalizing’ factor.

Regulatory actions in other sectors have impacts on the objectives of sustainable finance measures. If governments lean too far towards the relaxation of pollution controls, or providing major stimulus to the fossil fuel sector, and disparities in regulatory burden between green and brown assets broaden, transaction costs and compliance burdens for sustainable finance may increase.



5.

International Networks

The world of sustainable finance has developed very rapidly over the past few years, with new international initiatives extending to cover almost every segment of the financial and capital markets. Most notably, finance sector actors have federated in different ways, all characterised by a self-motivated wish to cooperate, share best practice and accelerate the transition to sustainable finance.

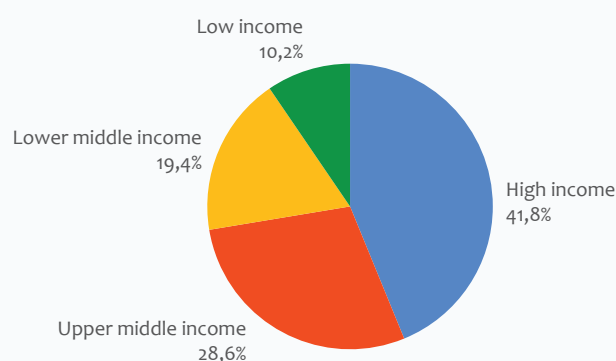
Many, like the Principles for Responsible Investment (PRI), the Principles for Sustainable Insurance (PSI) or the Sustainable Insurance Forum (SIF), group specific financial sector actors (respectively investors, insurance companies and insurance supervisors). Entities like the Sustainable Stock Exchanges initiative (SSE) confine membership to established stock exchanges and operate under a cooperative structure served by a light secretariat. Some, like the Network for the Greening of the Financial System (NGFS) have a public-sector membership – central banks and supervisors. Others, like the Alliance for Financial Inclusion, include significant public-sector players but focus on one aspect of the challenge – building financial inclusion, particularly in the sustainable finance space.

As of March 2020, international networks on sustainable finance bring together 106 countries/regulators, which account for approximately 90% of the world's GDP and trade. Together, they have an average overlap of 40% of their constituents (Figure 6) which presents a great opportunity to increase coordination and collaboration leveraging on each other's core competencies.

BOX 3. COMPOSITIONAL ANALYSIS OF MAIN NETWORKS

Analysis of the composition of the members of these networks shows that more than 70% of the members belong to either high-income or upper middle-income countries. International organizations can play a strategic role to further expand the impact of the work done in these sustainable finance regulatory networks in emerging and developing economies, including through expanding membership and supporting peer knowledge transfer.

FIGURE 6



FC4S is one of nine such international networks focused on accelerating the transition to sustainable forms of finance. Given the shared dedication to a common goal, it is clear that targeted cooperation would make each more effective in their own domain. It has long been the intention of FC4S to gather the other active players in the member financial centres to discuss how best to work together. The COVID-19 crisis offers an opportunity to do so, initially to discuss how best to respond to the crisis – both with short-term measures and to plot how best the economic recovery might privilege a move to more sustainable forms of development activities.

6.

Thoughts on a way forward

Once this crisis abates, there is potential for the COVID-19 pandemic to catalyze a durable shift towards an inclusive, low-carbon, and climate-resilient world. Looking to the wake of the 2008 financial crisis, many factors are different now, which can be strong footholds for this transition:

- The low-carbon transition is now a proven good investment. Renewable energy is now cheaper than fossil fuels in an increasing number of markets, commercial track records are longer, and investor trust is higher.
- There is clear evidence linking social issues to climate disruption, and investments in resilience to safeguard the health of citizens will increase as a priority.

However, many issues may constrain the scope for transformative action:

- The track record of learning from the past in the wake of disasters is mixed. Major impacts from previously ‘unknown’ exponential exposures (e.g. significant damage from hurricanes, flooding, wildfires) have not always resulted in effective strategies and investments in resilience.
- Social cohesion is likely to be extremely strained in the recovery period, stemming from widespread unemployment. Concentrated efforts will be required to guard against further deterioration that could act as a barrier to future resilience actions (e.g. strong climate policies).
- Legacy systems and infrastructure pertaining to disaster response were in bad shape before COVID-19 and may not be fit-for-purpose in a recovery world.

The balancing of markets in the aftermath of COVID-19 can only be considered a ‘recovery’ if it sets the economy on a path to address the **root causes** of the pandemic – the outbreak itself (biodiversity loss and destruction), and its spread (lack of international coordination) – as well as the **norms and practices** that are leading to an economic disaster (weak social protection, inadequate public investment in disaster response, etc.).

Going forward, an integrated model – linking social, economic and environmental resilience – can emerge in the wake of the pandemic if practical and coordinated actions are taken. Yet, there is an equal chance of the opposite outcome (unequal, unbalanced, isolationist and destructive) if economies immediately revert to a business-as-usual path. In practical terms, this will require three major shifts in thinking:

- **Integrating scenario-based analysis of exponential risks into all policymaking.** Governments need to better understand the economic, health and societal implications (costs) of a variety of scenarios (climate, pandemics) as well as the upsides (better health, future facing jobs, more stable and predictable tax bases, etc.).
- **Placing resiliency at the core of social and economic organization.** As the resilience of a globalized economic system will only ever be as strong as its weakest links, much stronger international coordination will be required to ensure that responses can be rapid.
- **Linking economic, social and environmental health together,** through a new agenda for public-private collaboration, and strengthened financial system governance. The scope for actions to align the post-COVID-19 financial system – and broader economy – with sustainability objectives is very broad. Success will require the efforts of a multitude of actors – how these independent activities come together will dictate potential for strengthening resilience. Clearly, financial regulatory measures put in place in the wake of the 2008 crisis have worked – we now need to think of what type of interventions will be needed in the wake of the pandemic to strengthen resilience not only of the financial system, but of the economy, society, and environment.



It is in this context that the F4S Network seeks to support deeper and wider collaboration between public and private actors to support the sustainable finance transition through the crisis, and in its wake.

We hope that this paper has inspired some reactions on what the sustainable finance agenda looks like through the crisis, and beyond. Over the coming months it is the intention of the FC4S Network to build on this initial Working paper. Additional outputs and analysis will be circulated to the FC4S community in July 2020.

ENDNOTES

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