United Nations Policy Dialogue Series: SDG-aligned Finance for Sustainable Development and Carbon Neutrality

Introduction

The global 2030 Agenda aims to realise a planet that can sustain everyone and a society that includes everyone, within this decade. The 17 Sustainable Development Goals (SDGs) offer a roadmap to achieve this for all stakeholders – not only governments, but also citizens, civil society and crucially, the business community, including financial institutions.

An integral part of the solution is effectively channelling public and private capital flows – large enough in both scale and scope – towards sustainable development and combatting climate change.

However, **COVID-19 – and the socio-economic crisis that followed – has undermined this, exacerbating an already large SDG-financing gap,** particularly in chronically underfunded developing countries. Following the pandemic, that gap rose by USD 1.7 trillion, to a total USD 4.2 trillion annually.[1]

While the pandemic has brought new difficulties to meeting the 2030 Agenda, it also offers valuable opportunities to fix fundamental faults in our society and build back better, through a more inclusive, fair and green recovery. A critical challenge in doing so is to ensure the financial system effectively supports a just transition.

This policy brief aims to shed light on that important imperative, by distilling key messages and policy recommendations that emerged during the **United Nations Policy Dialogue on SDG-aligned Finance for Sustainable Development and Carbon Neutrality,**[2] co-organized by UNDP and the International Institute of Green Finance (IIGF) of the Central University of Finance and Economics (CUFE).

The main message from the keynote speakers – which included experts from China's regulatory authorities – was on **leveraging the compatibility of green and inclusive finance.** This would enable financing for social progress to also support environmental protection, and vice-versa.

1. OECD (2020). Global Outlook on Financing for Sustainable Development 2021: A New Way to Invest for People and Planet, OECD Publishing, Paris.
https://www.oecd-ilibrary.org/sites/e3c30a9a-en/index.html?itemId=/content/publication/e3c30a9a-en
2. http://www.un.org.cn/special/FinanceforSDandCarbonNeutrality.html

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No. 3
Dec. 2021

Tackling climate change, the pandemic and the SDGs are systemic and interrelated challenges. Consequently, they must be addressed holistically, through a globally-coordinated approach. There is no "easy fix" or one-size-fits-all solution. A combination of measures, carefully calibrated for each local context, should be adopted to achieve the SDGs. In China, many financing opportunities harnessing the links between social and environmental factors can be found, supporting both national priorities and the SDGs.

"Greening inclusive finance and making green finance inclusive" solutions should be explored, to ensure that finance can drive both social and environmental outcomes at the same time.

The policy discussions of the expert panels center around three key messages:
i) aligning fiscal policy and public financial management with the SDGs and climate agenda;
ii) re-directing private capital to support the low carbon transition and;
iii) promoting international exchanges and cooperation.

1. Aligning fiscal policy and public financial management with the SDGs and climate agenda

The first series of policy suggestions and recommendations focused on addressing **how fiscal policy as a "package" can effectively influence behavior towards sustainable development.**

With public funding constraints exacerbated by the COVID-19 pandemic, **public finance must be carefully restructured, to better direct limited resources towards the SDGs and climate agenda.** Moreover, synchronizing policy instruments, such as taxation and subsidies, would improve the effectiveness of their application. Several necessary building blocks to align China's fiscal policies with the SDGs emerged from the policy discussions.

> Performance-based public budget management to advance sustainable development outcomes is needed. This calls for an effective and comprehensive planning, evaluation and tracking system, based on sustainable development indicators to raise the effectiveness of public spending and investments.

China has been implementing performance-based budgeting, which evaluates the performance of all public spending at both local and departmental levels. Environmental indicators are being integrated into the performance evaluation system.

To further optimize public funds management, a systematic and comprehensive data system and budget markers are required. This would be necessary to effectively review and track how public spending affects sustainable development. Such a system can help to inform necessary adjustments to the budget, enabling better alignment of public spending with sustainable development and national priorities in future.

> Broaden the set of measures available by mainstreaming nature-based solutions

Nature-based solutions (NBS) – such as restoring and protecting forests as carbon sinks, or bringing greenery into cities – can potentially contribute up to 20 percent of emission

reductions. Investing in them should be an important part of government financing and fiscal policy instruments, alongside other measures to tackle climate change and advance the SDGs.

For example, public funding to **build resilient and sustainable rural livelihoods for vulnerable groups needs to ensure that it also supports environmental conservation.** In China, less developed counties often overlap with ecologically important zones, making environmental protection their main path for development, as traditional industrial development is only allowed to a limited degree.[3] Overall, NBS can combine efforts to address interrelated sustainable development challenges, namely climate change, environmental conservation and poverty reduction.

Cost-benefit and impact analysis for a just low-carbon transition

The costs and benefits of investments in the SDGs, along with China's 2030 and 2060 climate goals, **are unlikely to be equally shared across different stakeholders and regions.** Given the rich diversity across provinces in China, fossil fuel-rich and dependent provinces, for example, will struggle to absorb the financial, economic and social costs of the industrial and energy transformation.

Furthermore, **future generations will disproportionally pay for the cost of inaction** by the current generation, causing inter-generational equity challenges, which should be taken into account in policy-making. Comprehensive policy and fiscal approaches will be needed to address the social aspects of the transition to a low-carbon economy, while enabling fair and inclusive pathways to net zero.

Encourage coordinated efforts to achieve a balanced green transition across regions by:

- **Setting a cap on total emissions,** in addition to carbon intensity targets, to properly allocate carbon caps at provincial levels and coordinate efforts across regions.
- **Considering local situations and developing customized regional action plans,** as well as roadmaps, to China's 2030 and 2060 goals.
- **Strengthening synergies between targets** for regional, industrial and sectoral low-carbon development planning.
- **Cross-regional planning and cooperation** through a pairing mechanism to leverage technological and financial advantages of developed regions, along with the ecological potential of less developed regions.
- **Referring to international instruments to help to address development gaps among some regions in China,** including the Clean Development Mechanism and Joint Implementation of the Kyoto Protocol, the Joint Crediting Mechanism of the Japanese government and the Internationally Transferred Mitigation Outcomes of the Paris Agreement.

3. Ecological zones are defined as regions that are significant to ecological security in water and soil conservation, the prevention of wind erosion, and protection of biological diversity. They enjoy targeted policy and are under regular inspection.

Leverage the potential of carbon pricing

Driving the low-carbon transition forward requires market tools that change relative prices to systematically price in long-term, negative externalities – such as environmental, social and health costs – generated by brown investments that must otherwise be borne by the public. The recently launched national carbon market is a significant step, building the market architecture to reduce emissions in selected sectors. Strengthening such mechanisms, as international experience has shown, will be a long, but pivotal process.

Specifically, two elements are crucial to ensuring that the emissions trading system (ETS) will effectively reduce carbon emissions:

- **Price signals.** The World Banks estimates that a modest decade-long increase in carbon prices to USD 50 per ton of CO2 is associated with a 20% to 25% reduction in emissions, versus a business-as-usual scenario, while carbon prices would have to reach USD 300 to USD 350 per ton by 2060 in China to effectively facilitate carbon neutrality. However, globally, the estimated average carbon price is USD 2 per ton of CO2, while in China it stands at around USD 4.

- **Emission caps.** Predictable and ambitious emissions cap trajectories would also be a strong signal supporting green investments, especially if combined with an effective auctioning mechanism for emission allowances that reward less-polluting companies and players.

Alongside ETS, emissions can be actively discouraged via "polluter pays" approaches, such as:

- **A carbon tax,** which can supplement China's ETS as a more efficient tool in driving behavior changes in sectors, such as transportation, agriculture, and construction.

- **Phasing out fossil fuel subsidies** is also necessary for successfully reaching carbon prices that reflect externalities from the use of fossil fuels.

The fiscal space gained from carbon pricing and reassessing budgets should be channelled to support vulnerable groups, for example, by subsidizing household energy transitions to offset the immediate, short-term impact on poor families.

Meanwhile, the low carbon transition calls for all of society to adjust their habits in line with sustainable development. Increasing consumer awareness and understanding about the issues at hand and support measures available to them would increase the acceptability of regulations and market mechanisms thereby making them more effective. This could be addressed through energy consumption campaigns to incentivize consumer behavioural changes and help households buy into the shift to clean energy.

2. Re-directing private capital to support the low carbon transition

Achieving carbon neutrality by 2060 in China entails efforts in two main areas: scaling-up green industries, while moving the carbon-intensive industry onto a net-zero path. In China alone,

this requires investments estimated to range between RMB 120 trillion to 170 trillion,[4] which is beyond the capacity of any government. Therefore, it is critical that the private sector is also fully on board. **Radical transformation requires exploring a multi-layered financial system, with diverse financing approaches suitable in different contexts and different industries.**

Examples of green and inclusive finance compatibility to support a fair low carbon transition:

- Facilitating access to financial services for energy-efficient, sustainable **small and medium-sized enterprises** (SMEs), along with their participation in green value chains. This can be done, for example, by taking carbon footprints into consideration when facilitating financial support to incentivize SMEs to adopt energy-efficient facilities.

- Financing the **agricultural sector** to cushion the negative effects of climate change on agricultural businesses, while strengthening the climate resilience and adaptation of rural households. An example would be developing water-saving agricultural techniques and water conservation facilities, as well as promoting eco-agriculture, which raises agricultural output with less environmental impact.

- Financing **rural development** to create eco-friendly, accessible job opportunities, while simultaneously reducing carbon emissions from energy use in rural areas. This could include, for example, developing distributed photovoltaic (PV) power generation that would generate new job opportunities, along with improving the energy efficiency of buildings in China's countryside.

Innovative finance in support of an accelerated transition

While green finance is evolving as a key tool to support the green economy and renewable energy development, supporting the energy transition of carbon-intensive industries is usually excluded from green finance by design. **Innovative instruments can complement existing green finance products** to help optimize industrial and energy structures, by broadening financing channels for enterprises with high carbon footprints and ambitions to decarbonize, but limited financial resources to do so.

A few practices of innovative financing instruments have emerged in China and globally:

- **Sustainability-linked bonds (SLB)** in China were launched by the National Association of Financial Market Institutional Investors (NAFMII). The first batch of seven SLBs were issued in May 2021 and the issuers were mostly carbon intensive companies in power, coal, steel, and cement industries. The key innovative features of SLBs are that the bond structure and terms must be linked to the issuer's transition outcome targets, compared with a business-as-usual scenario, rather than specific assets or projects. Financial terms can become even more preferential if targets are met.

4. Professor He Jiankun, Institute for Climate Change and Sustainable Development, Tsinghua University. October 2020. Available from: https://mp.weixin.qq.com/s/S_8ajdq963YL7X3sRJSWGg

- **SDG bonds** can play a critical role in ensuring a just, low carbon transition, as they reflect the relationship between social and environmental sustainability, taking into account connections between the SDGs. The French Development Agency (AFD) has issued cumulatively €3.5 billion (USD 4.1 billion) worth of SDG bonds under its newly released SDG bond framework, which replaced the 2017 climate bond framework. The new framework takes an "impact by design" approach, selecting loan projects according to potential contributions towards and/or negative impacts on one or more SDGs.[5]

- **Transition bonds:** In January 2021, Bank of China issued RMB 5 billion (USD 770 million) worth of transition bonds, both in RMB and USD denominations, making it the world's first transition bond issued by a financial institution via public offering. With this issuance, Bank of China aimed at nurturing investors with inclusive and long-term investment strategies that allow for different transition routes, covering a wider range of sectors than green financial products – e.g., hard-to-abate sectors – to support transitions towards net zero.

These types of bond issuances garnered attention from a group of diversified investors. Based on the experience in China as well as abroad, there are multiple challenges in scaling up these innovative financial products. Two issues were highlighted during the discussion:

1) The lack of clear and widely accepted definitions and standards for these products; and
2) Weak information disclosure, even for the more established green bonds, as well as assessment and evaluation procedures and institutions.

Against this background, the discussion recommended the following areas to support innovation in financial markets and, ultimately, to support China's climate and SDGs ambitions:

1) Establish clear standards, particularly for non-asset backed products, such as SLBs, thereby strengthening the guidance in identifying key performance indicators (KPI) and sustainability performance targets (SPT), on which an SLB is based. For example, KPIs should be relevant for an issuer company's future development strategy, while SPTs should be ambitious and different from the business-as-usual scenario.

2) Strengthen the informational disclosure mechanism and clearly define accountabilities for the issuer, underwriter, as well as verification agency. Transition-themed financial products should be based on a) an issuer company's clear industrial path for transition, with well-defined transition stages and respective targets, b) transparent information disclosure and c) certification of the transition from independent, accredited third-party agencies.

3) Standards and guidelines will need to consider the local context and dynamic nature of the transition, allowing a certain degree of flexibility. Transformation paths will vary across countries, as initial social and economic conditions differ. Given the emission-heavy nature of China's current energy and industrial structures, it is important for the financial system to effectively support the low-carbon transition of non-green sectors, too. International dialogue and exchanges are critical in this respect, as well as China's active participation in international standard-setting.

5. https://www.afd.fr/en/actualites/afd-unveils-its-new-sdg-bond-framework

Diversifying financing tools to increase financing efficiency

Different kinds of financing products have competitive advantages in financing diverse transition solutions correspondingly.

Indirect financing, such as green credit, is more likely to finance mature, well-developed industries, whose transition process requires larger-scale capital. Scaling-up green loans requires: 1) improving screening standards of green credit projects; 2) strengthening regulations around monitoring, evaluation and disclosure of green credit performance; 3) developing climate stress testing to improve risk-control systems; and 4) improving incentive systems by applying different regulatory measures for banks, based on their support towards carbon emissions reduction.

Direct financing, through venture capital and capital markets, could play an essential role in emerging technologies, such as lithium batteries and hydrogen, which require a higher degree of flexibility of financing terms and prices. In emerging sectors, direct financing can provide better financial support and optimize resource allocation, thanks to its relatively decentralized investment and financing decision processes, as well as risk-sharing mechanism. China's capital market, with its 180 million investors, 4,338 A-share listings and RMB 85 trillion-value, has great potential to support the country's low carbon transition.

Mainstreaming ESG among financial institutions

The concept of Environmental, Social and Corporate Governance (ESG) is rapidly spreading in China's financial markets, supporting investments in sustainable development of low-carbon industries. However, two key challenges facing the systematic application of ESG in China's financial markets are the establishment of **a mandatory ESG data disclosure framework, along with advancing alignment with international standards.** Chinese regulators are taking a step-by-step approach to close these gaps.

Apart from regulators, investors and financial service providers are also crucial actors in promoting ESG investments. **Stewardship**[6] (**尽责管理**) is a complementary tool for improving a company's ESG decisions, practices and outcomes, through active engagement between investors and investees/issuers, as well as voting. Even though relevant, stewardship has not been widely adopted by Chinese investors and service providers.

To further mainstream this concept and actively influence companies to develop sustainable practices, three suggestions were tabled for financial institutions: 1) build up human capacities for practicing stewardship; 2) prioritize engagement in policy-relevant areas for China, such as carbon emission peaking and carbon neutrality; 3) plan in advance and keep communicating with companies on their strategy and timeline on, for example, CO2 emission reduction targets.

6. For more details, please see: https://www.unpri.org/an-introduction-to-responsible-investment/an-introduction-to-responsible-investment-stewardship/7228.article

Integrating climate risks into financial practices

Climate risk management is as important as capital mobilization to ensuring the financial system effectively supports efforts in tackling climate change and SDG attainment. In this regard, financial institutions should better manage climate risks, including physical and transition risks.

In China, the central bank and commercial banks are making progress. The People's Bank of China (PBoC) has committed to incorporating climate risks into the macro-prudential framework and carrying out environmental stress tests in pilot financial institutions. Commercial banks, meanwhile, such as the Industrial and Commercial Bank of China (ICBC) – the first Chinese institution to join the Task Force on Climate-related Financial Disclosures (TCFD) – are starting to integrate environmental and climate risks into their organizational strategies, governance and risk management.

However, key challenges faced while integrating climate risks include:

1) A relatively limited availability of non-financial data, especially from non-listed companies, which are crucial to climate risk modelling.
2) Very often, financial institutions are developing their own individual methodologies for environmental stress testing, which are not comparable.
3) Information disclosure of "brown assets"[7] is needed to reduce the uncertainty from stranded assets risk exposure.
4) Difficulties in assessing transition risks for carbon-intensive industries.

Establishing climate risk databases and intelligent systems to enhance the capacity of climate risk identification, measurement, monitoring and reporting are key first steps. To do so, the following were brought forward as concrete recommendations:

1)Share non-financial data of companies with financial institutions and include this within the ESG rating system of financial institutions, to assess the ESG performance and climate risk of an investment.
2)Standardize environmental stress test models across different financial institutions for comparable results.
3)Standardize information disclosure on brown assets to enhance transparency and reduce transition risks.
4)Assess the financial risks associated with carbon intensive industries based on informed analytics, which should include an assessment of the policy environments, as well as the transitioning roadmaps of companies.
5)Leverage the potential of insurance and Fin-tech in facilitating climate risk mitigation. Fin-tech companies in particular can play a greater role in making intelligence and data visible, quantifiable, manageable and foreseeable.

3. Promoting international exchanges and cooperation

Considering the scale, scope and interconnectedness of current development challenges and the urgency for innovative, effective responses to scale up finance for sustainable development,

7. The speaker refers to carbon intensive and/or pollutant assets

international exchange and cooperation are essential to help develop feasible country-specific solutions, while building on lessons learned from others.

Mapping different efforts in SDG enabled budgeting

A few international best practices and case studies that China, as well as other countries, could benefit from are:

- The 2019 "wellbeing budget" in New Zealand, tackling low carbon and digital transitions, as well as social inclusion.
- France's "green budget," innovative in balancing both the positive and negative implications of public expenditures in brown and green assets.
- Mexico's integration of SDG classifications within its budgetary process.
- Indonesia's experience, which shows how a well-targeted combination of specific measures may prove effective in aligning national goals with the SDGs. In Indonesia's case, these include a tax reform, developing instruments such as carbon tax and green sovereign bonds, as well as removing fossil fuel subsidies.

Finally, several promising areas for international cooperation, particularly in designing guidelines and setting standards for sustainable finance, were mentioned during the Policy Dialogue. As China looks at adopting information disclosure standards aligned with those of the TCFD, sharing common challenges and experiences faced by financial institutions and regulators around the world would help to ensure consistency and effectiveness. International exchanges around ESG and green investment principles, along with efforts to address financial risks beyond climate change, such as those related to biodiversity, would also support efforts in China and other countries to realise a more green and inclusive future for all.

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