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INCLUSIVE GREEN FINANCE (IGF) WORKING GROUP

ROADMAP FOR INCLUSIVE GREEN FINANCE IMPLEMENTATION
SUMMARY

SPECIAL REPORT

This Special Report identifies inclusive green finance (IGF) as a subset of sustainable finance, shows that a successful IGF framework rests on six building blocks, and identifies five policy tools that further the framework. It also summarizes the related challenges and provides recommendations for IGF policy implementation.

Each AFI member has specific climate-related challenges and financial priorities. In that sense, the preferable pathway to IGF will depend on the context, priorities and size of the banking sector, the availability and readiness of credit financing schemes, the significance of the capital markets, the level of development of the digital retail payment system, and the size of the digital financial services market of the AFI member country.

FIGURE 1: ELEMENTS OF A HOLISTIC APPROACH TO IGF ("BUILDING BLOCKS")

Cover image: Baobabs trees, Madagascar. (ANTITES/iStock)
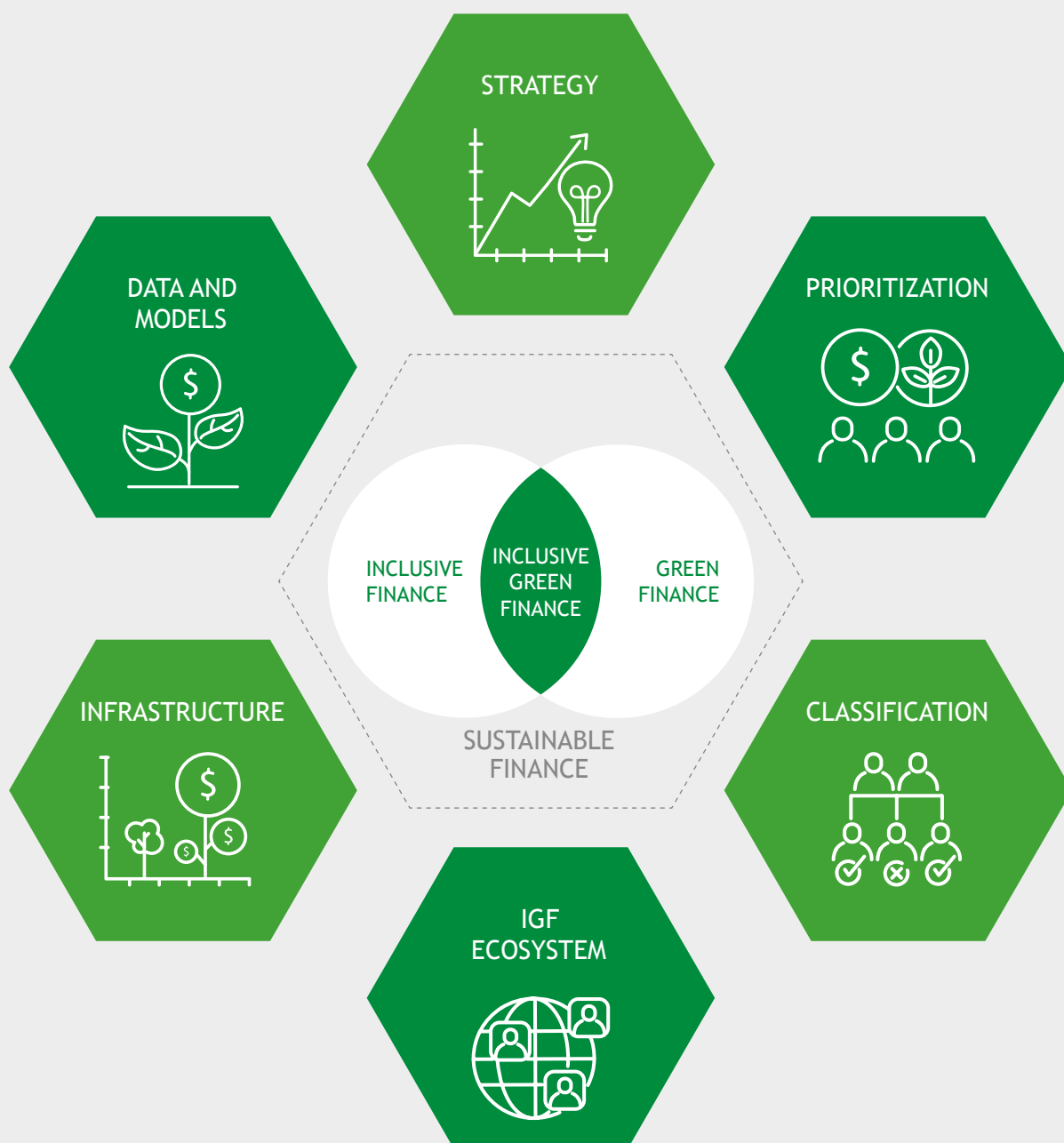
IGF policy is primarily a social goal that is coherent, holistic, supportive of financial inclusion and adheres to environmental factors. It is necessary for two reasons. First, due to a need for more reliable data regarding the future trajectory of climate change, markets could be better at assessing uncertain, long-term risks. Second, the benefits of IGF are primarily societal and long-term. As such, both IGF objectives are public goods. However, individual counterparties do not directly reap the full benefits from investments in financial inclusion and environmental protection. In the absence of public policy action, private actors tend to under-invest in financial inclusion and environmental protection.

BUILDING BLOCKS

This Roadmap to IGF Implementation has identified **six building blocks of an IGF framework**: strategy, prioritization, classification, data and models, ecosystem, and infrastructure (Figure 1).

> First and foremost, regulators at the highest level involved in financial regulation and central banking must adopt a **strategy on green or sustainable finance, including IGF**. This strategy needs to be accompanied by a governance structure and a dedicated coordinating entity in charge of implementing and ensuring the success of the IGF policy development and implementation. Some challenges may include an active sufficient regulatory capital for collective bargaining with multiple stakeholders, long-term financial resources to sustain the IGF strategy over time, and finding common ground with AFI neighbors to develop regional approaches.

> Second, regulators need to **establish IGF as a priority inside both financial institutions and regulators**, such as through sustainable banking principles and environmental, social, and governance-related risk frameworks. Establishing IGF as a priority needs to overcome pertinent issues, such as the interest of all stakeholders to avoid transition costs and risks and to leave profitable business unharmed, potentially resulting in a push for vagueness in regulatory releases, lack of granular milestones, and a passive approach to performance measurement.

> Third, a **classification** of IGF-compliant conduct, products, and services, either by way of a catalog or a taxonomy, becomes necessary to delineate wanted from unwanted economic behavior. Classification may come with some challenges, including finding coherent and consistent definitions across sectors and activities, avoiding binary classification results while incentivizing economic transformation, and adhering to both the short-term and long-term perspectives in assessing the sustainability of a given conduct or business activity. The issue of how externalities may be addressed in the risk policy and capital surcharge model established in the Basel Accord for financial institutions also falls under classification. As a rule, an externality does not impact the firm's balance sheet. As such, adding capital to combat externalities is beyond the risk logic of risk management and capital requirements as a standardized assessment of future risks.

> Fourth, **data and models** are at the heart of the IGF mission. However, typically, they are lacking at scale. Techniques that combine financial and sustainability data in models are in high demand to identify which data may be collected and used for data analysis. Likewise, data-driven models for lending and investment and algorithms for IGF-related operations are also needed. The Data and Model Building Block suffers from the under-investment in both granular data provided by economic actors on sustainability risks and factors and models linking sustainability and financial data. This has led to issues relating to (1) data availability, particularly disaggregated and aggregate data, and permissiveness of using estimates, (2) making use of existing data, including data models and rating models employed by existing rating and index providers, which comes with conflicts of interests, (3) impact, output, and success measurement of the approach applied, (4) setting the correct level of sustainability risk surcharge in light of the uncertainty in future developments, and (5) developing a sound methodology for output measurement.

> Fifth, the **IGF ecosystem** must be capable of delivering the elements for a market-driven, successful sustainable finance approach, including specialized auditors, lawyers, rating and index providers, data transmitters, technology solution providers, professionals in the financial sector, and advanced research and educational resources. An IGF ecosystem will lead to dynamic market development and create sufficient demand, which triggers the supply of specialist services. Some challenges resulting from a vibrant market environment may include increasingly conflicting interests among many agents involved in the IGF value chain.

> Sixth, a well-functioning IGF system requires foundational **infrastructure** and technical resources, including technical systems, to make monetary transactions and provide financial services. Building foundational infrastructures requires long-term certainty in conditions for investing and benefits.

Finally, all six building blocks of an IGF system face four fundamental challenges:

> staff qualification, as expertise goes beyond financial and regulatory knowledge

> capacity-building across the economy, financial industry, and regulators

> ensuring long-term political and financial support across all institutions

> dependency on advisors and institutions less familiar with financial regulation and banking principles, at least initially.

POLICY TOOLS

The six building blocks may be assembled in the proper order using various policy tools (Figure 2). Regulators best advance IGF policy development and implementation by applying the five groups of policy tools identified in this Roadmap to IGF:

> internal and external **advocacy for IGF**

> education and **capacity-building** of regulators, financial institutions, and the overall ecosystem with a particular view on the interlinkages between the financial and the natural science sustainability world

> **voluntary standards**, particularly best practices for lending and the standardization of green financial products

> **financial incentives** through credit guarantees, syndication, and other risk-sharing or green lending programs, as well as capital relief for prioritized sectors

> **mandatory regulation**, particularly reporting and disclosure, capital provisioning, and fiduciary duties to address the conflicts of interest emerging in any IGF ecosystems. Depending on the scope and national strategy, mandatory regulation may also be instrumental, e.g. binding classification system (taxonomy), setting IGF-oriented operating, risk and fiduciary standards and/or disclosure rules.

The building blocks and policy tools below complement each other to provide a sustainable roadmap to IGF framework implementation

FIGURE 2: POLICY TOOLS OF AN IGF FRAMEWORK

ADVOCACY FOR IGF

CAPACITY BUILDING

FINANCIAL INCENTIVES

VOLUNTARY STANDARDS

MANDATORY REGULATIONS
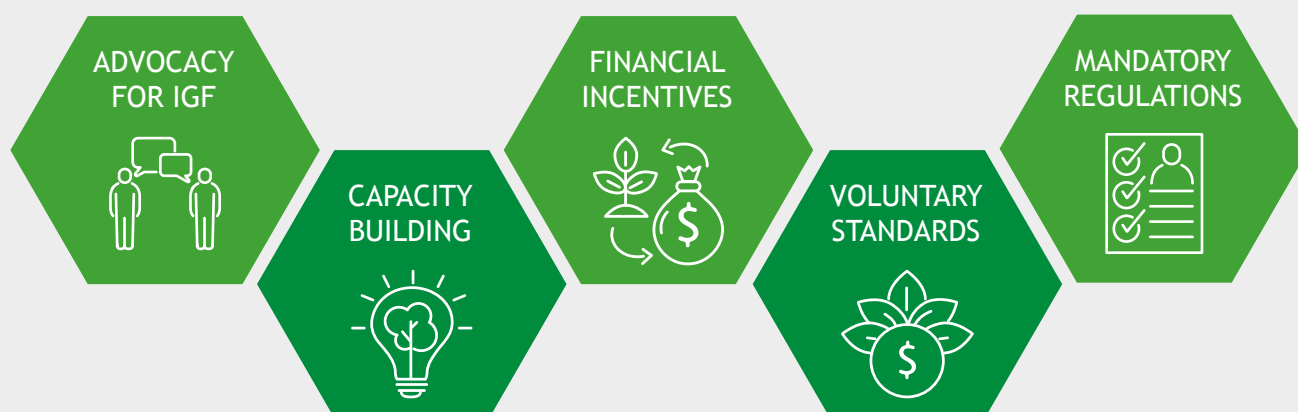
CONCLUSIONS AND RECOMMENDATIONS

IGF frameworks require solid, long-term political support driven by a **dynamic regulator with devoted expert resources** and **a substantial role in shaping the regulatory framework**.

Each regulatory tool requires gradual **refinement** in proportion to the capacity of regulators and regulated institutions. Members can start with Environmental and Social Risk Management guidelines and Sustainable Banking Principles of a more general nature and gradually supplement these principles with other relevant detailed elements.

While the exchange of knowledge and lessons learned with other countries remains essential, financial inclusion and climate change concerns differ from country to country. Therefore, solutions must be **country-specific and tailored to the needs of each AFI member.**

Young MSME behind his seasoning stand in Chorsu Bazaar, Tashkent, Uzbekistan. (Tarzan9280/iStock)