PRACTITIONERS'
DIALOGUE ON
CLIMATE INVESTMENTS

Green Banking Regulation – Setting out a Framework

Federal Ministry
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Foreword

The “Practitioners’ Dialogue on Climate Investments” (PDCI) seeks to facilitate a better understanding of policy instruments and transformative processes that shape enabling framework conditions for private climate investments. The PDCI offers a platform to policy makers from developing countries and emerging economies to engage with industry and financial sector representatives. Hence, PDCI events also provide an excellent opportunity for businesses and financial institutions to present their climate products and services to governments and to other enterprises.

PDCI focuses on smart public incentive schemes, effective regulatory frameworks and innovative financial mechanisms with the aim of encouraging more private investment in climate change adaptation measures, energy efficiency improvements and renewable energy projects.

Summary

This policy brief discusses the case for central banks and other financial authorities to devise green banking frameworks and regulation and outlines the sustainable banking frameworks that are currently being developed in Bangladesh, the Dominican Republic and Pakistan as prototypes within the framework of the Practitioners’ Dialogue on Climate Investments (PDCI). The paper describes the challenges of implementing green and sustainable financial market regulation and provides policy recommendations for regulatory authorities that consider introducing such regulations.

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1. Introduction

Over the last years a number of developing countries has introduced green or sustainable banking regulation or is in the process of doing so. These initiatives are very timely with regard to the current challenges of financing both the implementation of the Agenda 2030 and the agreements of the Paris climate conference in December 2015 where 195 countries agreed to decarbonise their economies and limit climate warming to less than 2° reaching even for 1.5° Celsius. After the successful year 2015 in which the course for a sustainable development in its four dimensions – economic, social, ecological and ethical – has been determined in the political arena, the year 2016 has to focus on the implementation of these goals. Given the extent and the ambition of the agreed goals, private capital will be essential to finance the necessary transformations. It is hence of utmost importance to align the financial system with sustainable development (UNEP Inquiry 2015), i.e., to make sure that all investment and lending decisions are taken based on environmental screening and risk assessment to meet sustainability standards. Against the backdrop of the central importance of bank financing in virtually all developing and emerging economies, it will be important for financial authorities to provide adequate guidance to commercial banks on how to incorporate sustainability considerations into their business models.

The purpose of this policy brief is threefold: First, it discusses the case for central banks and other financial authorities to devise green banking regulation. Second, it presents three case studies of banking regulations that are currently being developed in Bangladesh, the Dominican Republic and Pakistan as prototypes for the Practitioners' Dialogue on Climate Investments (PDCI). And finally, it describes the challenges of implementing green and sustainable financial market regulation and provides general policy recommendations for regulatory authorities that consider introducing such regulations.

2. Reasons for (developing countries') central banks to analyse environmental risk and enhance green finance

Traditionally, central banks and other financial authorities would have no business in dealing with climate change and other environmental challenges. Even though the mandates of regulatory authorities differ from country to country, environmental considerations are usually not included.[1] However, there are good reasons for central banks and other regulatory authorities to tackle the combined challenges of mitigation, adaptation and sustainable development.

First, given the environmental challenges related to climate change and the interrelated devastating natural disasters, environmental protection has been on the agenda of many developing countries since several years. However, these countries often do not have strong and powerful ministries of environment, whereas their central banks and other financial authorities are typically very influential. Incentivising sustainable investment and enforcing environmental standards may be easier achieved in many developing countries through financial sector policies implemented by financial authorities rather than by purely environmental regulation.

Second, many of the countries where central banks and other financial authorities have started to develop green banking frameworks are facing particularly severe environmental challenges that require decisive action.

[1] In many cases, central banks' mandates include maintaining long-term price stability, sustainable growth, and employment, as well as ensuring stability of the financial system.

Examples include high adaptation needs to the imminent sea level rise due to climate warming as in the Dominican Republic or the threat of natural disasters as in Bangladesh. But also an urgent need to increase energy access for large parts of the population or, as in the case of Pakistan, the extreme unreliability of the energy system with frequent power shortages, which might be solved by enlarging renewable energy capacity, are motives for promoting green banking. These specific risks and challenges have in common that they directly impact on the countries' economic productivity. Energy shortages may also lead to high energy costs and cause inflationary pressure, reducing the overall consumption capacity.

Third, systematically addressing climate and other environmental risks may also be necessary to safeguard the stability of the financial sector. For instance, the Governor of the Bank of England, Mark Carney, has repeatedly pointed out that regulatory authorities should take into account the risks of climate change to increase the resilience of the financial sector. While it is straightforward that risks related to climate change may directly affect the insurance sector, they may also adversely affect the lending portfolios of banking institutions or the assets under management of institutional investors.

In sum, environmental and climate change challenges can pose material risks to both the real economy and the financial sector and should hence be on the radar of financial authorities.

Green banking versus sustainable banking

While the transformation towards a low carbon and climate resilient economy is in many cases the strongest motive for the implementation of green banking regulations, the term green finance should normally imply a more comprehensive understanding of "green". In accordance with the definition of green finance in Lindenberg (2014), the scope of green banking regulation should not only include the prevention, minimisation and compensation of damages to the climate, but more general, to the environment including investments in environmental goods and services (such as water management or protection of biodiversity and landscapes).

Similarly, the label sustainable banking should encompass the complete Agenda 2030 with all of its 17 goals, including also subjects such as gender equality.

For obvious reasons the introduction of green banking regulation with a narrow focus on climate and energy related economic activities faces much less resistance than more ambitious environmental regulations. For comprehensive sustainability regulations opposition among stakeholders can be expected to be even stronger. Therefore, the State Bank of Pakistan currently introduces only a green banking regulation framework while Bangladesh Bank, the central bank of Bangladesh, is now widening the scope of its green banking regulations that were introduced in 2011 by designing sustainable finance policies for banks and financial institutions in Bangladesh.

Concrete benefits of fostering green banking

Green banking guidance can first of all help to catalyse green banking and climate investing by mobilising private and institutional capital (for example from pension funds) for green investment and thus diversify investment opportunities and sources. Moreover, a green regulatory framework can help to redirect the flow of resources from environmentally damaging to climate-friendly economic activities and help to expand sustainable and green businesses. Thus, by giving businesses the means to invest while helping tackling climate change challenges can facilitate the needed long-term production transformation in many developing economies.

Green banking guidance creates a level playing field by avoiding competitive distortions if environmental risk assessments are carried out only by few banks. Green banking guidance can also contribute to capacity building by commercial banks in the area of environmental risk assessment and knowledge of financing green economic activities. By this, the green banking guidance can help financial institutions to prepare for the upward potential of green business avenues and likewise open the access to international financial sources, for instance of the Green Climate Fund (GCF), through enhanced green knowledge.

Besides, it can help them to fulfil their responsibility to protect the environment as part of their corporate social responsibility (CSR) activities by reducing their own carbon footprint and the negative climate implications of their clients' businesses.

Last but not least, green banking guidance can help to reduce the credit default risks of the banks' borrowers and by this contribute to mitigate commercial banks' overall risks.

Different forms of green banking guidance

Financial authorities can choose between different instruments to establish guidance on green banking (see **Fehler! Verweisquelle konnte nicht gefunden werden.**). Green or sustainable banking regulation provides specific mandatory instructions for governance or lending. However, the term regulation is also used in many cases as synonym for guidance in general and can encompass all three instruments, i.e. regulation, policy and guideline. A policy is a specific mandatory instruction for a certain financial activity, while a guideline is supporting both, a regulation or a policy, with additional guidance on how to implement it. In most cases a guideline will provide minimum standards and suggestions that are necessary to fulfil to comply with the regulation or the policy.

In the end, which of the three different instruments will be chosen by financial authorities for providing green banking guidance to the financial sector can also be a strategic decision. Pakistan, for instance, will start with formulating green banking guidelines with the intention to make their intervention more rigorous in the future by adding specifying policies and/or regulations once the guidelines have been broadly accepted.

Box 1: Definition of different forms of green banking guidance

<table>
<tr><td>REGULATION:

Specific mandatory instructions for
governance or lending</td><td>POLICY:

Specific mandatory instructions for
financial and business activities</td></tr>
<tr><td colspan="2">GUIDELINE:

Providing suggestions and guidance
("How to implement")</td></tr>
</table>

Source: Authors' compilation based on PDCI group discussions.

3. Green and sustainable banking regulations in Bangladesh, the Dominican Republic and Pakistan

As illustrated in Figure 1, which depicts the 21 countries represented in the Sustainable Banking Network – a knowledge-sharing network of banking regulators and banking associations established in 2012 that supports the development of environmental and social risk management by financial institutions and promotes green and inclusive lending – a growing number of countries has already introduced green finance guidelines and regulations. This section will briefly discuss the current state of green or sustainable banking frameworks in Bangladesh, the Dominican Republic and Pakistan.

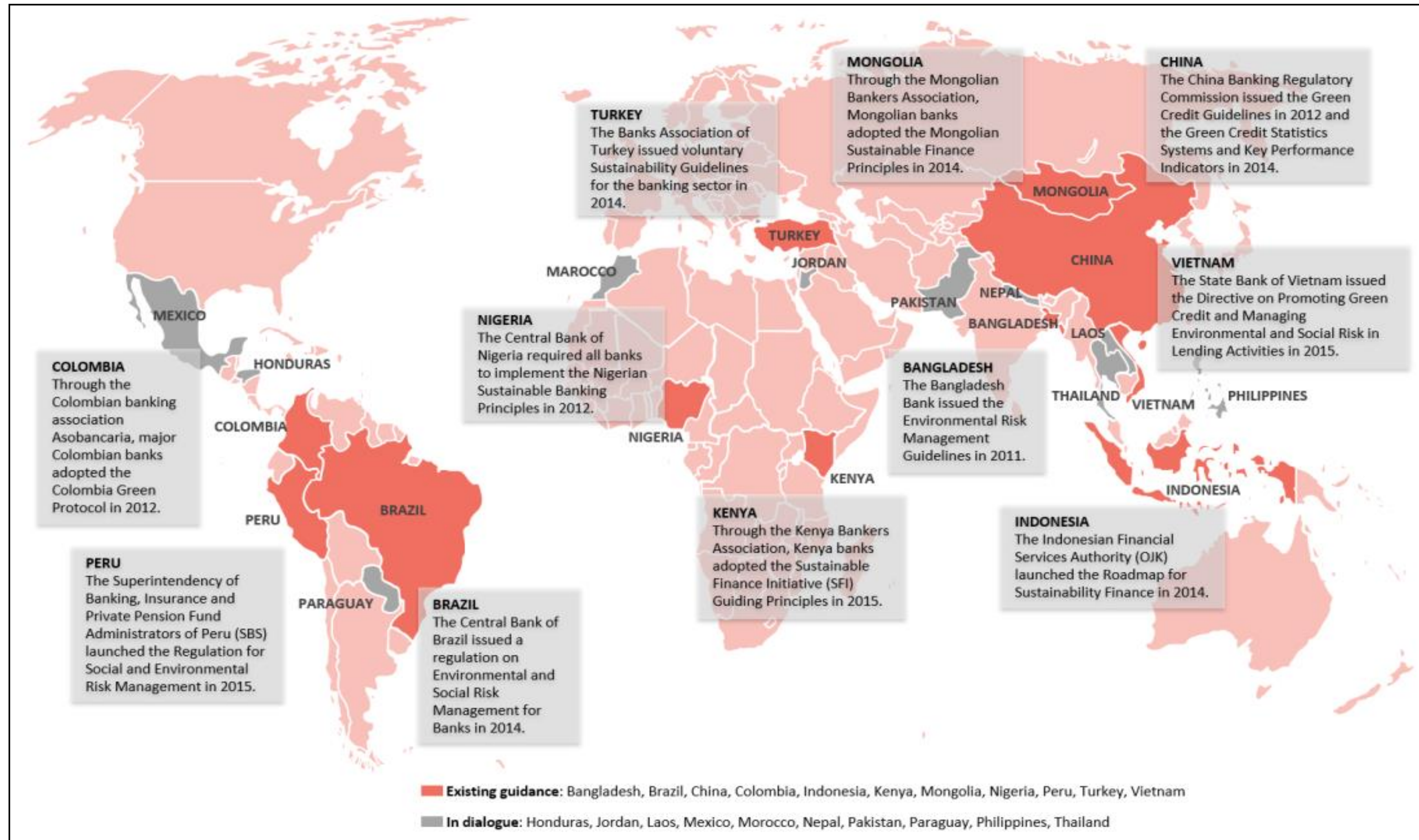
Broadly speaking, green regulations encompass three pillars: (i) guidelines for environmental risk assessment, (ii) own impact reduction, and (iii) green business facilitation. Examples for each of the pillars are provided in Table 1.

Table 1: Examples for elements of green banking regulations

(i) Guidelines for environmental risk assessment	(ii) Own impact reduction	(iii) Green business facilitation
Environmental due diligence	Enhancing water and energy efficiency and use of renewable energy for bank's buildings	Refinancing schemes for certain product lines
Guidelines for environmental risk management	Solar power system for ATMs	Green credit guarantee facilities
	Measure own carbon footprint	Green credit lines
	E-Recruitment, Online Salary, Online Office orders etc.	Green funds for certain investments
	E-tendering in procurement	

Source: Authors' compilation based on PDCI group discussions.

Figure 1: Sustainable Banking Network members and countries having introduced green finance guidelines and regulations



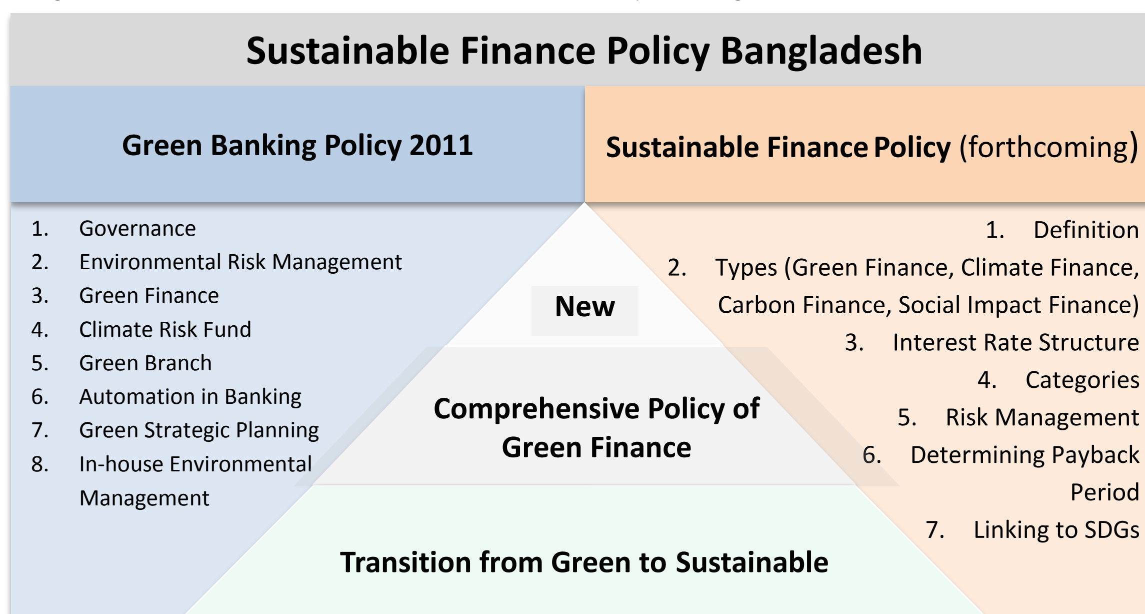
Source: Volz (2016b).

Sustainable Finance Policy for Banks and Financial Institutions in Bangladesh

Already in 2008, Bangladesh Bank published a circular on 'Mainstreaming Corporate Social Responsibility (CSR) in Banks and Financial Institutions in Bangladesh'. In 2011 Bangladesh Bank issued 'Policy Guidelines for Green Banking' for banks and extended the guidelines to non-bank financial institutions two years later. In 2014 the central bank set mandatory annual targets for green finance and created three different support lines for green finance in 2012, 2014 and 2016, respectively. Since 2015, at least 5% of banks' loan portfolios have to be allocated to green finance. However, the term green finance has not been defined appropriately and also the mandatory target has been set in a way leaving room for loopholes and interpretation, undermining the intended goal.

Apart from addressing limitations of the existing regulation, Bangladesh Bank now also attempts to expand the scope of their green guidelines to support the implementation of the sustainable development goals of Agenda 2030 and focus more on adaptation. Therefore, Bangladesh Bank is currently designing a comprehensive sustainable finance policy for banks and financial institutions. In 2015, Bangladesh Bank released a draft of 'Updated Guidelines on Environmental and Social Risk Management for Banks and Financial Institutions' which is currently at final stage for issuance. The new regulation aims at catalysing both investment in ecological and sustainable sectors and assisting the country in achieving the SDGs and a green transformation of its economy. Green finance will be developed further to sustainable finance in a broader sense. Figure 2 illustrates the value added of the new sustainable finance policy in Bangladesh compared to the existing green banking policy of 2011.

Figure 2: Value added of Sustainable Finance Policy in Bangladesh



Source: Authors' compilation.

As lessons learnt from the limitations of their green regulation, Bangladesh Bank will particularly focus on providing clear and precise definitions of all relevant terms, including not only the definition of "sustainable finance" but also all measures and terms that are used to describe their regulatory targets.

Reforms in the banking regulation system in the Dominican Republic to strengthen climate adaptation

The Dominican Republic as a small island developing state (SIDS) is particularly confronted by climate change and sea-level rise as well as natural disasters. Due to this vulnerability, the Central Bank of the Dominican Republic is contributing to design mechanisms to help the country's financial system to channel domestic savings to support private sector efforts to enhance energy efficiency using clean renewable sources. This way, the central bank could set free the equivalent of one percentage point of bank reserves so financial institutions could provide loans to businesses to encourage them to transition from traditional fossil-based energy sources to sustainable ones.[2]

The idea is to contribute to the country's effort to supplement international technological transfers and financial assistance with domestic resources to tackle the challenges of climate change and reduce greenhouse gas emissions in line with the national development strategy.

Given the Dominican Republic's electricity generation deficit, its domestic financial market must be more supportive of certain private sector initiatives. Specifically, those initiatives that serve as both, purpose of climate change adaptation and, as a collateral benefit, job creation. There are previous experiences in the country of freeing up bank reserves to support economic sectors to boost GDP growth. For example, in 2009, 2012 and 2015, the central bank intervened to bolster production in areas such as manufacturing, construction (including housing), agriculture, and a range of small and medium enterprise operations that helped stimulate economic growth during those years.

Furthermore, the financial authorities in the Dominican Republic, which include the central bank, the Superintendence of Banks, and the Ministry of Finance, are engaging in a broad dialogue to foster consensus around a set of reforms for the financial system, including banking and securities market regulations. One focus of their regulatory approach is to devise a strategy for designing financial vehicles for climate finance to encourage the inclusion of small and medium enterprises to support policy efforts for climate adaptation and the consequent transformation of the production function of its economy. It is worth noting that the Dominican Republic already has tax incentives in place for renewable energy.

Green Banking Guidelines for Pakistan

With the implementation of Green Banking Guidelines, the State Bank of Pakistan seeks to nudge banks and financial institutions towards the development of green and climate-friendly strategies. The aim is to provide a holistic approach on how to adapt to climate change, take the necessary precautionary measures and envisage new business opportunities. The State Bank of Pakistan's Green Banking Guidelines provide minimum standards for green banking and cover, apart from guidelines for environmental risk assessment of new financing and existing portfolio, adequate financial instruments to support green investments and resource efficiency measures to reduce the carbon footprint of bank operations.

Figure **3** shows how the green banking guidelines build upon the already existing framework in Pakistan. Of the three pillars of the green banking guidelines – risk management, market facilita-

[2] Freeing one percentage point of bank reserves could provide over USD 200 million of domestic investment into clean energy.

tion and own impact reduction – two are embedded in a series of similar guidelines. The new environmental risk management guidelines build on the central bank's experience with risk management guidelines for credit risk, interest rate risk, market risk and operations risk. Besides, Pakistan has already introduced prudential regulation for SMEs, housing, agriculture, microfinance and corporate lending as well as differentiated capital adequacy requirements. Similarly, the market facilitation pillar for green financing products and services can benefit from the central bank's experience with priority area lending guidelines for agriculture, housing developers and infrastructure projects, with credit guarantee facilities for SMEs, micro borrowers and young entrepreneurs as well as the knowledge gained with the refinance facilities for exports, import substitution and SMEs.[3] Last but not least, the impact reduction targets in the third pillar relating to banks' own resource efficiency are a completely new field for banks in Pakistan.

Figure 3: Envisaged scheme for green banking guidelines in Pakistan

Source: Authors' compilation.

[3] The PDCI policy brief on "Promoting Green Finance – Refinance and Credit Guarantees" by Mehdi Mustafa (2016) describes in detail some of the concrete instruments that will be introduced for this purpose.

4. Challenges to implementing green and sustainable banking regulations

The following major challenges to implementing green banking regulation frameworks have been highlighted by experts of the central banks of Bangladesh, the Dominican Republic and Pakistan.

The first challenge is the regulatory strength of the central bank and other financial authorities to design and implement a coherent regulatory framework and its standing in the national political environment as well as in the finance sector. Structural issues might arise among government agencies to coordinate a comprehensive set of policies and reforms in order to mobilise savings and climate finance. In particular the role of environment ministries as partners is important as they might feel threatened by a new enrolment of the central bank and other financial authorities and a subliminal conflict of power might crop up. Alternatively, if financial authorities and the environment ministry do not coordinate, a situation may result where the green banking regulation is not in sync with the policies adopted by the environment ministry.

A second challenge relates to the state of financial system development. On the one hand, a well-developed financial system will facilitate the introduction of green financing instruments, such as green bonds. On the other hand, less developed financial systems might offer the possibility to adapting to green banking practices more smoothly, as there are less path dependencies.

A third challenge relates to resistance to change from the financial institutions under regulation. Depending on their willingness to cooperate, the introduction of the new regulations might cause frictions and resistances. In addition, the success of the new banking regulation will depend on the capacity of commercial banks and non-bank financial institutions to implement the regulatory provisions. Furthermore, their ability or inability of identifying business opportunities in financing climate friendly economic activities will affect the effectiveness of the regulation.

A fourth important challenge, in particular for countries with a high share of poor population, is how to frame the regulation in a way that it also incorporates a development component, so that also the poor can benefit from the new regulation. Since adverse effects on financial inclusion must be avoided, financial authorities may be reluctant to put an extra burden on the banks.

Last but not least, the regulation itself needs to be suitable and proportionate, i.e., regulators need to have a detailed understanding of financial markets and their inherent obstacles and barriers.

5. Policy recommendations

Drawing on the experiences of Bangladesh, the Dominican Republic and Pakistan, the following policy recommendations can be deduced for financial authorities that are aiming to design and implement green and sustainable banking regulations and frameworks:

1. To avoid resistance, it may be wise to start with voluntary guidelines and introduce mandatory regulation or policies only after a certain transition period. Green and sustainable banking regulation should provide minimum standards while giving at the same time incentives to go beyond.

2. It might be easier to start with a green regulation in the narrow sense, i.e. targeting only climate and energy related economic activities, and expanding the scope in later revisions to a more comprehensive sustainability concept.

3. In order to avoid any conflict of power among actors, relevant government agencies should be taken on board as early as possible.

4. In much the same way, the financial sector should be invited to focus group discussions addressing the need for and benefits of green and sustainable banking regulation as early as possible to pave the way for a smooth introduction of the regulations and address concerns and objections before they manifest.

5. The regulation itself has to be defined in a very precise and clear way to avoid any possibility of circumvention. At the same time the regulation should be as easy to understand as possible.

6. The regulation should be understood as a dynamic, living framework for two reasons. First, it is essential to monitor the efficacy of regulatory measures to adapt them if necessary to achieve the desired effect and avoid adverse side-effects. Second, in order to support the transition towards a sustainable future, new developments and technologies have to be incorporated continuously in the guidelines; otherwise financial authorities would risk not making use of their full transformative potential.
7. The implementation of green and sustainable financial market regulation has to be accompanied by timely capacity building of banks and financial institutions.

8. In order to assure adequate monitoring of policies and regulations, the financial authorities should request banks to report regularly (monthly or quarterly) on their progress of implementation.

6. Literature

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