Inquiry: Design of a Sustainable Financial System

UNEP

The United Kingdom: Global Hub, Local Dynamics

MAPPING THE TRANSITION TO A SUSTAINABLE FINANCIAL SYSTEM

January 2016

The Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme 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 its final report, *The Financial System We Need*, in October 2015.

More information on the Inquiry is at: *www.unep.org/inquiry* and www.unepinquiry.org or from:

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Comments

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EXECUTIVE SUMMARY

The UK's transition towards a sustainable financial system is shaped by a dynamic between domestic green economy priorities and its role as a global financial centre.

With financial assets worth eight times annual GDP, the UK financial system is disproportionately large when compared to the underlying domestic economy. The City of London is not only home to some of the world's largest financial markets, but also to a range of sustainable finance initiatives that are setting the agenda both domestically and internationally. Historically, it was the key location in the initial rise of carbon markets and a leader in the integration of environmental, social and governance factors into institutional investment. It is now a pioneer in confronting climate risk. The UK has also become a global centre for Islamic Finance, a striking example of how the public and private sectors have cooperated to develop a strategic competence in a growing area of values-based finance.

The crisis that followed the 2008 credit crunch had enormous costs for the UK economy, and profoundly impacted the structure and governance of UK financial markets. The continued prevalence of market abuse and high-profile scandals in the aftermath of the crisis has inspired a renewed vigour by regulators and legislators, with recent efforts to restore trust and public confidence focusing on market integrity and professional conduct. Importantly, the focus on stability risk has also changed the ways in which sustainability is being considered by firms and regulators – notably by shifting attention from the institutional to the systemic level.

Over the past 15 years, four "waves" of sustainable finance innovation have taken place in the UK, starting with ethical investment, moving to mainstreaming environmental factors into institutional investment, the surge of post-crisis reform and the current focus on climate and carbon risk. Across these, a UK model of innovation emerges – one starting with social entrepreneurs and civil society organizations raising expectations for financial institutions, practitioners competing to capitalize on new market expectations and finally regulation being introduced to universalize good practice.

Currently, there are six priority areas for sustainable finance in the UK:

1. Social innovation: aligning finance with individual values and social purpose – for example, from leading work on 'unburnable' carbon and stranded assets to new thinking about the overall purpose of the financial system.
2. Institutional stewardship: placing sustainability factors at the heart of mainstream financial sectors, most notably investment management – for example, the Law Commission's review of fiduciary duty.
3. Capital market mobilization: incorporating sustainability into equity and debt market disclosure, analysis and capital raising – for example, mandatory reporting of greenhouse gases on the London Stock Exchange. Green bonds are also critical growth area: the UK was the third largest green bond market in 2015.
4. Housing finance: improving the environmental and energy performance of the UK's housing stock through new ways to mobilize financing – for example, finding a practical successor to the Green Deal mechanism.
5. Prudential governance: embedding sustainability into the safety and soundness of key sectors and the system as a whole – for example, the Bank of England's review of insurance and climate change.
6. Public balance sheet: mobilizing fiscal and other resources to facilitate the transition to a low-carbon, green economy – for example, the launch of the world's first Green Investment Bank.

The UK's leadership in many areas is clear. But sustainability could perhaps be classified as a 'sleeping giant' of the financial system. Initial innovation is sometimes developed in the UK, but then deepened by fast followers in other markets. Many of the promising initiatives are also relatively new and will need careful nurturing to flourish.

Heading into 2016, the global momentum is likely to intensify, not least through China's decision to make green finance a core theme of its G20 Presidency, launching a new study group co-chaired by China and the UK, for which UNEP will act as secretariat. Domestically, the dialogues that contributed to this country report revealed significant enthusiasm for the development of a clear roadmap for sustainable finance in the UK. This would seek to build on existing innovations, overcome key bottlenecks and identify shared priorities for future action. A number of countries are introducing national roadmaps – notably China and Indonesia – and based on the findings of this report, a UK Sustainable Finance Strategy could take forward the following priorities:

- **Deepen sustainability disclosure and analytics:** Disclosure on UK capital markets is improving, but could be deepened on climate, food and water.
- **Confirm the sustainability dimensions of stewardship, fiduciary duty and investment structure:** Improving sustainability performance in the investment chain is not just a question of rules, but also developing pension funds with the scale and capacity to deliver.
- **Establish a Green Bond Hub:** A UK Green Bond Market Development Committee would help to consolidate existing market innovation and provide a platform for future growth.
- **Empower individual investors with the right information:** Innovative use of communications technology could bring information on the sustainability of investment funds to the consumer, strengthening financial literacy.
- **Build on the track record of the Green Investment Bank:** The Green Investment Bank has considerable potential to facilitate capital deployment as it moves into its next phase, addressing market failures that remain pressing issues.
- **Enhance financing for the greening of the UK's homes:** Breakthrough ideas are needed to develop ways of financing home retrofits that are attractive and compelling for the consumer.
- **Take a system-wide view on environmental risk:** The Bank of England's prudential review of insurance is world-leading, and the lessons could be applied to other sectors and parts of the system, such as banking and pension funds.
- **Explore the green potential of alternative finance:** The UK is Europe's leader in alternative finance – such as peer-to-peer – and this could be leveraged for the green economy.
- **Embed sustainability into financial culture:** Following the crisis, considerable attention has been placed on improving financial culture. The sustainability dimension could now be incorporated as an additional motivational driver for improved conduct over the long-term.

1 THE UK FINANCIAL SYSTEM: LARGE, GLOBAL AND CONNECTED

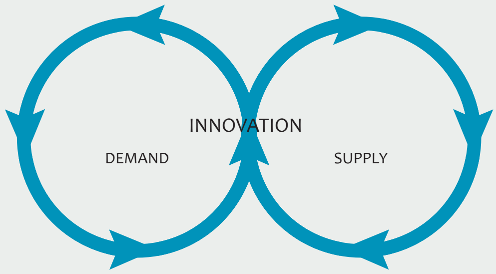
1.1 The Transition to a Sustainable Financial System

The purpose of the financial system is to serve the real economy – by facilitating transactions, enabling capital intermediation and managing risk. This is a dynamic task – and currently one of the critical challenges facing the financial system worldwide is to support the transition to low-carbon, resilient and sustainable development. For the UK more than most, this challenge has a dual meaning as the real economy that its financial system serves is both domestic and international.

The Dynamics of Supply and Demand for Sustainable Finance

Mobilizing capital to support the transition to sustainable development requires action on both the demand and supply sides of finance.

On the demand side, policies in the real economy need to price externalities, remove perverse subsidies and encourage long-term capital deployment towards the green economy through stable and cost-effective investment frameworks.



These steps need to be complemented by action on the supply side – to improve risk management within the financial system, encourage innovation in green financial services, strengthen resilience to environmental shocks and ensure coherence between financial rules and wider national priorities. The Inquiry's focus is on policy options that can improve the supply side of finance. environmental shocks and ensure coherence between financial rules and wider national priorities. The Inquiry's focus is on policy options that can improve the supply side of finance.

This paper provides an overview of the evolution of the UK's approach to sustainable finance and concludes with a set of priorities that could be included in a comprehensive national roadmap. Critically, the UK's approach to sustainable finance is informed by the structure of its financial system.

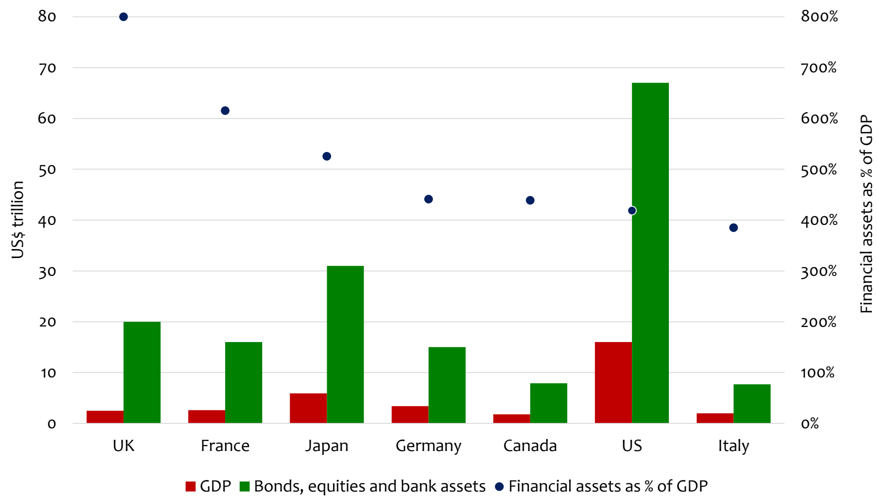
1.2 Key Features of the UK Financial System

The City of London has been ranked second only to New York as the world's leading financial centre,[1] and in terms of total financial assets, the UK is third behind the US and Japan. However, the UK financial system is disproportionately large when compared to the underlying economy, with assets eight times annual GDP, the largest in the G7 (Figure 1).

The financial and insurance service sectors contributed £126.9 billion in gross value-added (GVA) to the British economy in 2014, representing 8% of total UK GVA.[2] This share is large in comparison to other

OECD countries of similar size: slightly higher than the US, and in the EU area, only lower than that of the Netherlands and Luxembourg.

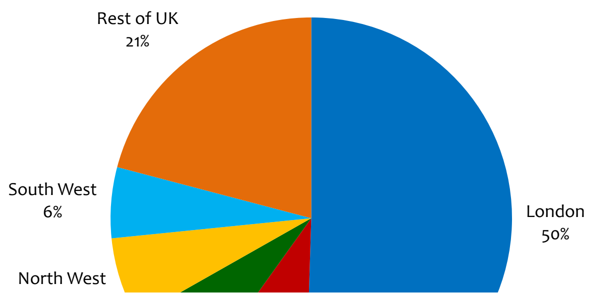
Figure 1: Financial assets vs. GDP



Source: World Bank data

The UK financial system is centred in London and the surrounding geographic area (the South East region), which together accounted for nearly 60% of total financial and insurance sector GVA in 2012 (Figure 2).[3] The next most important UK financial region is Scotland. Edinburgh has been the UK's primary Northern financial centre for centuries, and has for many decades played an important role in energy and commodities finance. Many prominent UK financial institutions remain headquartered in Scotland, including RBS Group (Edinburgh), Aberdeen Asset Management (Aberdeen), and the newly re-established TSB Bank (Edinburgh). Cities such as Leeds and Manchester act as regional hubs, with Bristol emerging as a hub for social and green finance.

Figure 2: Regional breakdown of UK financial and insurance industry GVA, 2012



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