Inquiry: Design of a Sustainable Financial System

2° Investing Initiative

UNEP

Building a Sustainable Financial System in the European Union

THE FIVE 'R's OF MARKET AND POLICY INNOVATION FOR THE GREEN TRANSITION

March 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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The 2° Investing Initiative

The 2° Investing Initiative (2°ii) is a multi-stakeholder think tank working to align the financial sector with 2° C climate goals. Our research seeks to align investment processes of financial institutions with 2° C climate scenarios; develop the metrics and tools to measure the climate performance of financial institutions; mobilize regulatory and policy incentives to shift capital to energy transition financing.

More information on the 2° Investing Initiative is at: *www.2degrees-investing.org*

About this report

This paper has co-authored by the UNEP Inquiry (Jeremy McDaniels and Nick Robins) and the 2° Investing Initiative (Diane Strauss, Jakob Thomä and Stan Dupré). Errors and omissions remain the responsibility of the authors. This report is part of the Sustainable Energy Investment Metrics project (SEI Metrics) and has received funding from the European Union's Horizon 2020 research and innovation programme under grant agreement No 649982. The report reflects only the authors' view and the European Union's EASME is not responsible for any use that may be made of the information it contains.

Comments

Comments are welcome and should be sent to *nick.robins@unep.org*.

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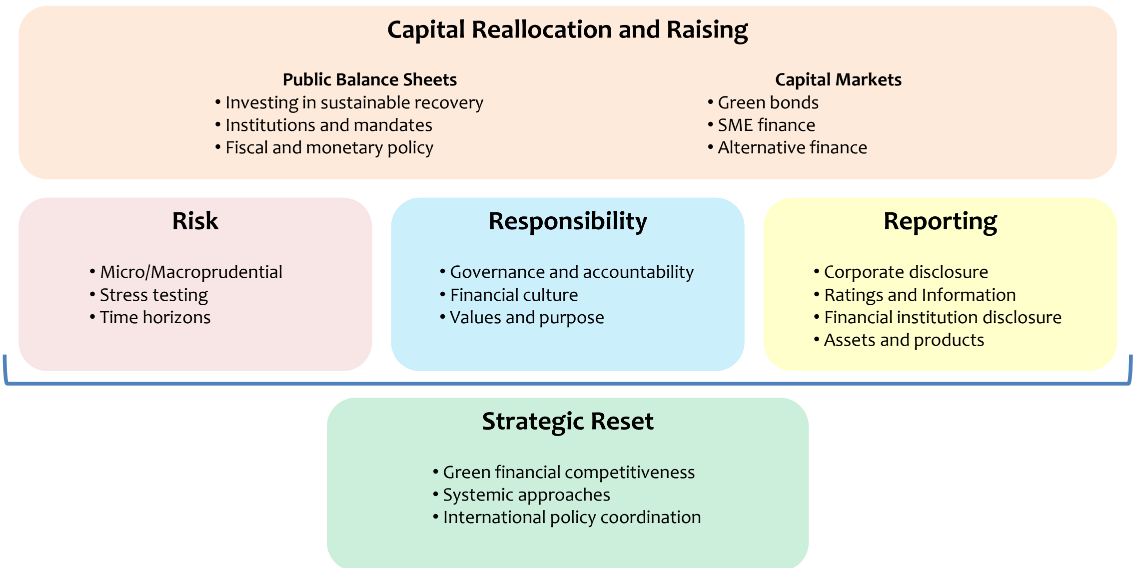
EXECUTIVE SUMMARY

Over the past 20 years, the European Union (EU) has often been at the forefront of efforts to build a financial system that supports sustainable development. A growing number of social entrepreneurs, mainstream financial institutions, as well as public investment banks have led these efforts. Increasingly, European financial policymakers and regulators are exploring their role in enabling an orderly transition to a prosperous low-carbon economy. This report presents a stock-take of actions under way at the European Union level and in selected Member States to align the rules governing the financial system with environmental sustainability. This is a fast-moving debate, with global developments such as China's launch of the new G20 Green Finance Study Group pointing to the strategic nature of the agenda.

The European Commission (EC) estimates that up to €2 trillion will be required to meet the policy goals of the Europe 2020 Strategy for smart, sustainable and inclusive growth. The scale of the investment challenge has prompted a new focus on the strategic role of financial policy and regulation in harnessing the EU financial system. In this context, building a sustainable financial system can contribute to economic recovery by allocating capital to new growth sectors, as well as improving the efficiency and effectiveness of the capital intermediation process through improved risk management, better flows of information and a core alignment with long-term social purpose.

Looking across the range of innovations across the EU, five broad policy priorities emerge. The central challenge of financing sustainable development in the EU is one of capital **reallocation**. Enhancing frameworks for **risk management**, clarifying the core **responsibilities** of financial institutions and improving **reporting** and disclosure across these dimensions will be necessary to fully unlock flows of sustainable finance. A growing number of Member States are delivering on individual aspects of these priorities, and others are acting within given asset classes. The debate is now advancing to the system level and the need for a strategic **reset**, seeking to link previously unconnected initiatives and to enhance the capacity of the financial system to support renewed economic competitiveness and improved sustainability performance.

Figure ES1: The 5Rs of sustainable finance



Priority 1. Reallocation

Public Balance Sheets

Following the financial crisis, willingness to mobilize public balance sheets to promote long-term economic growth objectives has increased. Inflecting this momentum to support investments necessary for sustainable long-term growth is a key priority for the roll-out of the Juncker Plan. The European Fund for Strategic Investments has mobilized roughly €50 billion – translating to 15% of the €315 billion target of the Juncker plan – during its first six months of operations, with over half of approved projects in sustainability-related areas including energy and climate action, environmental and resource efficiency, transport, and research and development.

The EU's regional and national public investment institutions – such as the European Investment Bank (EIB), Germany's KfW, France's Caisse des Dépôts et Consignations (CDC), and the UK Green Investment Bank (GIB) – are recognized leaders in supporting new markets for green investments, and prefiguring emerging practice in the private sector through new green market standards for lending. In countries such as France, fiscal incentives are channelling household savings to SME finance and local infrastructure. At the Union level, a debate is emerging around how the European Central Bank could realize its Treaty mandate to support sustainable development, with discussion focusing on its quantitative easing (QE) programme. In a speech given at the COP21 climate negotiations in Paris, Banque de France Governor François Villeroy de Galhau noted the importance of current monetary policy in encouraging "investment in longer-term projects, with better returns than government bonds, such as infrastructures and energy transition", within the context of broader macroeconomic objectives.

Capital Markets

With the Capital Markets Union (CMU) action plan, the EU is putting significant effort towards mobilizing Europe's financial system to better serve the real economy. Crucial to this is developing effective approaches to serve the emerging industries of the future in terms of green infrastructure, clean technology innovation and resource-efficient SMEs. Leveraging debt capital markets through the use of green bonds is gaining increasing attention from both market institutions and policymakers. At present, however, neither European Member States nor the Union as a whole have developed a long-term strategy for this promising area, which is needed to ensure market integrity and scale up volumes. Enhancing access to finance for resource-efficient SMEs through alternative finance channels such as peer-to-peer lending also has potential, one that is still as yet largely unexplored. At a systemic level, promoting capital market competitiveness through green finance is emerging as a priority. For example, the UK's City of London has just launched a new Green Finance Initiative.

Priority 2. Risk

Awareness of the potential for sustainability factors to pose prudential risks has been building among Member State financial regulators, largely focused on climate and carbon factors. A cluster of leadership is emerging which is being recognized globally. The Bank of England's Prudential Regulation Authority (PRA) recently published an assessment of climate risk to the UK insurance sector, identifying how physical, transition and liability risks may affect firms and policy holders. This approach has now been taken up by other European central banks, and by the Financial Stability Board at the global level. In Sweden, the Financial Services Authority (FSA) published an assessment of banks' internal rules for credit and lending from an environmental perspective in December 2015, and is intending to publish an assessment of the impacts of climate change on financial stability in 2016.

Bringing future shocks into today's decisions will be critical in overcoming what Bank of England Governor Mark Carney has termed the "tragedy of horizon" in factoring sustainable development into financial decision-making. Going forward, the European Union has a major opportunity to pool resources and connect different initiatives and approaches. This includes sustainability stress testing, building on leading initiatives, such as France's recent decision to integrate climate factors into stress tests for banks.

Priority 3. Responsibility

EU Member States have been leaders in the design of financial policies and regulation that integrate non-financial factors within the core responsibilities of financial institutions. Of the 14 jurisdictions globally where regulators now require pensions funds to disclose information on their approach to environmental, social and governance (ESG) issues, 10 are located in the EU. An increasing number of Member States – including the Netherlands, Sweden and the UK – have gone beyond simple disclosure to clarify that fiduciary obligations do not preclude the consideration of material sustainability factors in the investment process. This debate is part of a broader shift occurring across the EU, as new societal expectations drive change in the way financial institutions understand their core responsibilities to consumers, clients and future generations. Emerging lessons from the integration of key ESG issues point to the importance of embedding sustainability factors into the incentives, skills and values that drive financial culture. Efforts to realign finance with social purpose are under way from the individual to the systemic level – in the Netherlands, an oath for banking professionals encodes ethical conduct into all professional behaviour.

Priority 4. Reporting

Effective reporting and disclosure is a foundational element of a sustainable financial system – enabling consumers to pick the right financial products, investors to make informed choices, and regulators to assess threats to financial system resilience from sustainability-related shocks. Frameworks for corporate and financial institution disclosure in European countries are at the leading edge of this evolving agenda: corporate disclosure of greenhouse gas (GHG) emissions is now mandatory in a number of European countries, including Denmark, France and the UK. Progress is advancing at the Union level with the implementation of the Non-Financial Reporting Directive. However, multiple barriers remain – as well as significant fragmentation. Sustainability disclosure by financial institutions – to shareholders, stakeholders, beneficiaries and broader civil society – is also becoming a core area of regulatory focus. The new French Energy Transition Act is the most comprehensive climate disclosure regime in the world, with multiple requirements on listed companies, banks and investors. France is also enhancing transparency at the product level, with sustainability labelling schemes to be implemented in 2016.

Priority 5. A Strategic Reset

European Member States are scaling up sustainable finance innovation. This is now being matched by a growing number of initiatives at the EU level, including consultations on long-term and sustainable investments,[1] non-financial reporting,[2] and new research initiatives. However, many of the efforts are relatively new – and address only some aspects of the sustainable finance landscape.

The fast-moving nature of the sustainable finance agenda means that there is now an important opportunity to explore how these national and EU innovations can be taken forward at a strategic level. Developing an **EU Strategy for Sustainable Finance** could help drive synergies between sustainability targets and economic growth objectives at the Union level, while boosting international competitiveness as new markets emerge. Such a strategy could cover the following themes:

1. **Reset:** Assess ***strategic challenges and opportunities*** for the harmonization of existing sustainable finance efforts within the EU and key areas for future work, in order to clarify thinking in advance of broader EC processes on finance through 2016.

2. **Reallocation:** Develop a ***Green Capital Markets Plan*** as a complement to the core CMU: this could provide guidance to facilitate the issuance of green products as well as the greening of equity and debt markets, encourage the integration of sustainability factors in ratings and research, and clarify market creation roles for public finance institutions.

3. **Risk:** Establish a ***Finance and Sustainability Risk Forum*** to institutionalize information sharing on how sustainability factors may affect prudential risks, potentially linked to the European Systemic Risk Board.

4. **Responsibility:** Clarify the ***sustainability dimensions of investor duties and financial responsibilities*** by bringing together pensions regulators. This could be an initial catalyst for EU-level guidance on how best to integrate sustainability priorities within frameworks for investor governance in both common law and non-common law countries.

5. **Reporting:** Measure ***sustainable finance flows***, focusing on redirection of capital to low-carbon investments at national and regional levels. Such efforts represent an important first step in monitoring progress towards a sustainable financial system in the EU.

Theme	Priority Area	National Policy Leadership
Capital Reallocation: Public balance Sheets	EU Budget allocation	France: The EIB has partnered with CDC to deliver a €2 billion funding line for French SMEs and the energy transition
	Market standards and guidance	UK: The GIB Greening Handbook sets out practical tools to assess, monitor and report the green impact and performance of investments
	Market creation	Germany: KfW provides low-interest rate loans for SMEs for energy efficiency refurbishment and construction UK: The GIB has been instrumental in kick-starting the investment trust market for financing renewable energy projects
	Engaging in capital markets	Germany: KfW issued its first green bond of €1.5 billion in July 2014 and has announced a green bond purchase programme
	Fiscal incentives	France: Livret A and FCPI schemes provide tax incentives for individuals, utilizing savings for investments in SMEs, local infrastructure and social housing
	Monetary policy and QE	France: Commentary from Governor François Villeroy de Galhau regarding importance of climate change for central bank mandates and the role of monetary policy
	Collateral frameworks	
Capital Reallocation: Markets	Greening capital markets	UK: Green Finance Initiative launched by City of London Corporation in January 2016, focusing on green bonds
	Green bonds	Increasing leadership on green bond principles across many countries
	SME finance	Germany: Evidence suggests that increased banking diversity can enhance SME access to finance
	Alternative finance	UK: a targeted regulatory regime has helped facilitate major growth, with the UK now holding 80% of the rapidly growing EU alternative finance market
Risk	Prudential risk assessment	UK: Bank of England PRA review into climate risks to the UK insurance sector, identifying physical, transition and liability risks
	Systemic risk	Sweden: FSA submitted a report to government on how climate change will affect financial stability in March 2016.
	Stress testing	France: Energy Transition Law stipulates that the government will publish a carbon and climate risk stress test report of the financial sector in 2016
Responsibility	Fiduciary duty and investor governance	Netherlands: New pensions legislation implies that that taking account of sustainability issues is an integral aspect of the "prudent person" principle
	Stewardship and engagement	UK: World's first Stewardship Code implemented in 2010, inspiring similar efforts from many other countries
	Performance measurement	
	Incentives and remuneration	
		France: White Paper on Ecological Transition specifically recognizes need for investor