Inquiry: Design of a Sustainable Financial System

UNEP

The State of Sustainable Finance in the United States

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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:

Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*

About this report

This paper has been prepared by Cary Krosinsky, with sections on Insurance and Conservation Finance provided by Gabriel Thoumi.

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Comments

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

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EXECUTIVE SUMMARY

While US financial institutions have at times enjoyed a reputation of being something of a laggard on sustainability issues versus their European counterparts, significant changes and innovations are under way which are beginning to drive meaningful change.

Record levels of awareness on sustainability issues in the US, including from millennials, are accelerating activities such as:

- Increased levels of sustainable and responsible investing.
- An increased focus from the largest US banks and other financial institutions on sustainability risks, lending practices and related opportunities.
- US insurance companies and related regulators are also developing and evolving sustainability risk frameworks.
- Federal and State policies are accelerating the ongoing US low carbon energy transition.
- Financial innovation is driving meaningful change in many investment sectors while social innovation and culture development also continue to evolve.

With energy costs curves seen as changing for the long term, levelling the playing field for lower carbon energy production, and interest in having a positive impact with investment dollars from millennials on the rise, a top-down, bottom-up race is under way which has created an important new dynamic leading to these actions.

Accelerating these trends further can help make the US a leader on both designing and enabling sustainable financial systems.

INTRODUCTION

The US has enjoyed the benefits of, while helping design and evolve what is arguably the most successful and innovative economic system in the world.

US markets continue to dominate global finance, which can be readily seen from a number of perspectives, including:

- US institutions own the largest component of global debt and equity ownership at 31.9%[1] with New York City and Boston representing two of the three largest global cities managing assets overall.[2]

- As of the end of 2012, North American (mostly US) asset managers oversaw 54.7% of the assets managed by the largest 500 asset managers in the world.[3]

- Institutional ownership of public companies is also concentrated, with the largest 1000 US-listed companies being owned 73% by institutional investors, with much of this managed in the US.[4]

- A majority of the largest 100 public companies in the world are domiciled in the US.[5] US stock exchanges also dwarf all others in terms of overall market capitalization,[6] and the US has the largest annual GDP in the world.[7]

- Similar primary relevance is seen in assets managed in the US across asset classes from private equity to venture capital to hedge funds among other relatively recent forms of finance, investment and trading mechanisms which have arisen primarily as a result of US-originated innovation.

US businesses also have a successful history of taking their once well-honed practices overseas, and so the opportunity to scale US sustainable finance practices in other countries is another important dynamic to potentially encourage for financial and societal success.

For the sake of global sustainable financial systems, which are increasingly interconnected, the directionality of US markets is therefore of primary importance, given the influence, creativity and assets under management in the region.

The question of how we can know whether the US is headed towards a sustainable financial system is salient, and we believe it can be answered through an analysis of five trends as follows:

1) Sustainable investment, banking and lending practices in the US
2) The US insurance industry and credit risk
3) Federal and state policy, disclosure and actions
4) Financial market innovation
5) Social innovation and culture

1 SUSTAINABLE INVESTMENT, BANKING AND LENDING PRACTICES IN THE US

Interest in Environmental, Social and Governance (ESG) issues in the US is on the rise with one recent study showing ESG factors reflected in some way at US$6.57 trillion of assets managed in the US as of 2014, a growth of 76% since 2012.[8]

Mutual funds are the largest component of global public equity ownership (over 22%), with most of these dollars owned in the US.[9] Ownership of these vehicles is increasingly static and held in well-developed active and passive strategies, through vehicles such as 401(k) plans and other forms of long-term, defined contribution pools which encourage holding portfolios for the long term.[10]

Equity mutual funds in the US available to the public with ESG factors as primary considerations have been a small historical component of this picture,[11] arguably resulting in a meaningful gap between present day mutual fund strategies and achieving a better integration of ESG issues within investment in general.[12] But significant changes are being seen of late, with sustainability factors increasingly studied and implemented by investors into their strategies. 2015 in particular has seen significant changes to this previous disconnect starting to unfold.

Firms such as BlackRock are now attempting to increasingly consider the cost of climate change to investments,[13,14] and Bank of America Merrill Lynch has a new, strong focus on this area as well.[15] Some US asset owners have made significant moves through efforts such as the PRI's new Climate Change Pilot Framework for Action.[16] Pension Funds such as the New York State Common Retirement Fund have accelerated their low carbon efforts during COP21,[17] however, there is a way to go for US fund managers to vote in favour of climate change resolutions, which many of the largest US institutions still do not.[18]

Box 1 : Three Recent US Climate Research and Investment Commitments of Significance – Goldman Sachs, Bank of America Merrill Lynch, BlackRock

1) In November 2015, Goldman Sachs increased its commitment to its clean energy investment activities to US$150 billion by 2025, quadrupling its previously stated goals. Energy transition success likely will require both significant capital commitments and investment/risk-return profile creativity, and across different asset classes, making increased involvement from firms such as Goldman Sachs significant and welcome news.

Earlier, in July 2015, it previewed this step when it joined a White House effort to get US businesses to act on climate change along with Alcoa, Apple, Bank of America, Berkshire Hathaway Energy, Cargill, Coca-Cola, General Motors, Google, Microsoft, PepsiCo, UPS, and Walmart with stated goals at the time including a) increasing energy efficiency (a key needed wedge in the climate transition, expected to be as much as US$1 trillion per year in new investment globally according to the IEA), b) boosting low-carbon investing and c) making solar energy more accessible to low-income American families.

BOX 1 (CONTINUED)

2) Also joining this White House pledge was Bank of America, and who has also committed to nine figures of environmental sustainability, in this case US$125 billion in low-carbon business through lending, investing and related efforts. These two banks clearly see financial opportunity in addition to understanding their essential role as enablers of what is needed for greater society, creating a potentially useful positive dynamic of seeking financial performance alongside societal positive benefit.

3) In November 2015, BlackRock, the world's largest asset manager with US$4.5 trillion in assets, published a twelve-page White Paper entitled "The Price of Climate Change, Global Warming's Impact on Portfolios". The report outlines challenges arising from climate change along with recognition of the specific potential to affect asset prices in all areas alongside suggested investment solutions. BlackRock now manages more than US$200 billion of assets across environmental, social, and governance and impact investment portfolios.

Individual investor interest in ESG has also been on the rise, at 71% according to a recent Morgan Stanley survey, even though this has not yet been matched by professional US advisors, most of who recently stated that they remain disinterested.[19] This was further confirmed by a recent August 2015 CFA Institute Survey entitled "How do ESG issues factor into investment decisions?" which found its America region members to be least likely to use ESG within decision-making:[20] a clear opportunity is emerging for large US financial institutions to better embed sustainability awareness in their professional ranks in order to better address the increase in client interest being expressed.

Figure 1: Consideration of ESG issues in investment analysis and decisions