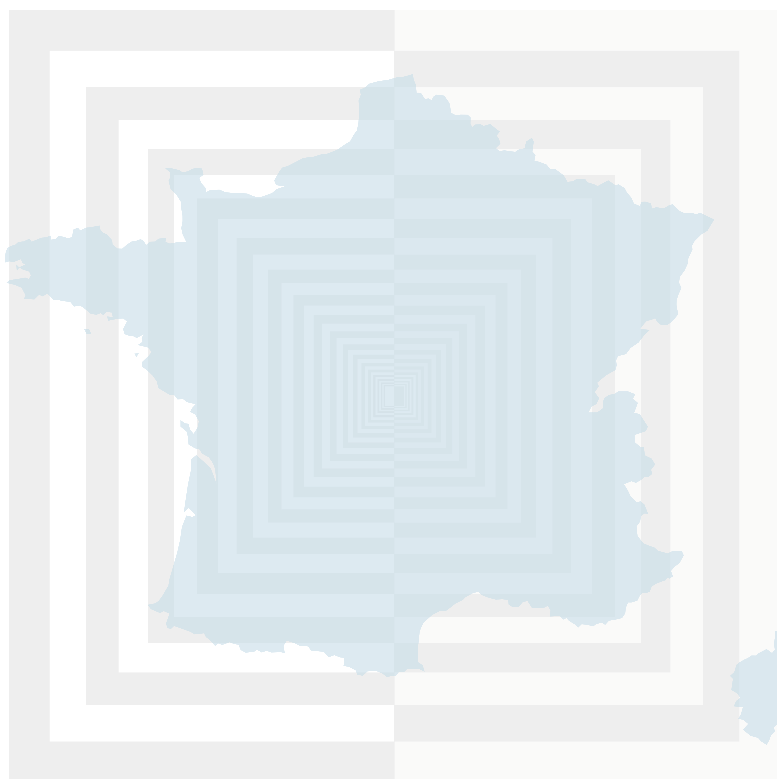
Inquiry: Design of a Sustainable Financial System

I4CE INSTITUTE FOR CLIMATE ECONOMICS
Une initiative de la Caisse des Dépôts et de l'Agence Française de Développement

UNEP

France's Financial (Eco)system

IMPROVING THE INTEGRATION OF SUSTAINABILITY FACTORS



November 2015

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 in October 2015.

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

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This Briefing

I4CE – Institute for Climate Economics – is an initiative of *Caisse des Dépôts* (CDC) and *Agence Française de Développement* (AFD). This think tank provides independent expertise and analysis when assessing economic issues relating to climate and energy policies in France and throughout the world. I4CE aims at helping public and private decision-makers to improve the way in which they understand, anticipate, and encourage the use of economic and financial resources aimed at promoting the transition to a low-carbon economy.

About this report

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EXECUTIVE SUMMARY

In the run-up of the COP21, much international attention is focused on France. While mainly related to climate change negotiations, this creates an opportunity to take a broader look at French domestic policies and practices on sustainability. This report presents the French financial system and draws lessons from the French ongoing experience in improving the integration of sustainability issues that could be shared with other countries.

The present report summarizes and analyses the key initiatives and dynamics at stake in France. It focuses on both the climate-related issues that have recently received significant attention and the development of broader Environmental, Social and Governance (ESG) issues over the past twenty years. The dynamics that have shaped the last two decades have both led to and been influenced by the emergence of an 'ecosystem' of commercial, public and non-profit actors and experts involved in the appropriation and integration of sustainability issues across the sector.

Using the framework of analysis presented in the UNEP Inquiry global report, this case study examines the landscape of actors, private initiatives and public policy that has driven the emergence of this ecosystem and helped foster capacity building and the acquisition of expertise among sectoral actors.

A DEVELOPED AND DIVERSIFIED FINANCIAL SYSTEM THAT PLAYS AN IMPORTANT ROLE IN FINANCING THE 'REAL' ECONOMY

The French financial system is large and sophisticated, totalling €12 trillion of assets with different types of institutions playing important roles in collecting and channelling savings to finance the 'real', or non-financial economy. Credit institutions managing €8 trillion are the dominant, but not the only players such as insurance companies and asset managers that together manage €4 trillion of assets. These institutions – alongside regulated savings products – enable a diversified allocation of household savings. Therefore, French economic actors have access to steady flows of finance on relatively good terms, whether through the banking network or debt market products.

BUILDING AN INCREASINGLY SUSTAINABLE ECOSYSTEM THANKS TO THE INTERACTION BETWEEN PUBLIC AND PRIVATE INITIATIVES

The ecosystem of French actors involved in better integrating sustainability in the financial sectors relies on four major pillars: government policy, non-profit expertise, commercial expertise and financial operators. This had measurable impacts as, for example, more than 1% of GDP was channelled annually to 'climate' investments between 2011 and 2014 (I4CE 2015).

The interactions between actors within the ecosystem are rich and synergetic. Indeed, legislation may sometimes be inspired by private initiatives implemented by actors within the financial system; conversely, the legitimacy of individuals and institutions holding expertise on sustainability is sometimes reinforced by the implementation of dedicated legislation.

The French regulatory framework on sustainability in the financial sector consists of three principal milestones, each of which has focused on improved extra-financial reporting for both companies and institutions financing them. In 2001, the New Economics Regulation law formalized the reporting requirements on ESG issues based on pre-existing practice nascent among financial institutions. In 2010, the 'Grenelle II' law expanded reporting requirements in terms of content and to directly include asset managers. Finally, the 2015 Law on Energy Transition for Green Growth has been the most recent step in this process, introducing a coherent package to foster an improved assessment of both climate-related and the contribution of financial actors to the energy and low-carbon transition.

Sustainability issues have mainly been tackled through reporting requirements, focusing on improving the availability of information, fostering the development of market-wide expertise, and incentivizing improved risk assessment. Moreover, these reporting requirements are often seen as flexible and adapted to a large range of institutions and issues as they are based on a supervision-oriented approach increasingly attuned to sustainability issues.

ADDRESSING CAPITAL MOBILIZATION ISSUES THROUGH A MIX OF PUBLIC AND PRIVATE INITIATIVES

Traditionally, fiscal and industrial policies are often seen as the most relevant tools to foster capital mobilization for sustainable and climate-related investment in France. However, targeted public interventions have been seen at times as necessary to tackle specific market failures or foster the development of markets. In France, direct public intervention to mobilize capital occurs through a number of smaller interventions focusing on enabling private initiatives to emerge, rather than one or two large-scale 'silver-bullet' policies. These initiatives are designed to complement the role of the private sector to tackle the broader capital mobilization challenge, focusing principally on market structuring and the development of expertise.

While relatively small compared to total financial sector flows, public financial institutions such as the Caisse des Dépôts and Bpifrance play a role to leveraging regulated savings accounts (Livret A) and other public and private sources of capital to provide financing in line with public sustainability mandates in areas where other market actors are not able or willing to do so. They committed to mobilize €15 billion towards low-carbon transition by 2017. They are also an opportunity to test and implement specific policies to better drive capital towards sustainability-friendly actions.

Similarly, the French government has fostered publicly supported labels to help the identification of ESG and climate-friendly financial products – and more broadly to build a common knowledge base and base standards for activities.

Finally, the predominant place of French institutions in the initial development of the green bonds market is an illustration of the development of expertise in France, whether by financial or non-financial institutions and experts.

AN INNOVATIVE PACKAGE OF MEASURES TO IMPLEMENT MINIMUM RISK ASSESSMENT AND DISCLOSURE THROUGH SUPERVISION

The integration of climate-related risk disclosure in the 2015 Law on Energy Transition for Green Growth (ETGG) focused the international spotlight on the dynamics occurring in France. The law can be considered

as a coherent package aimed at giving individual institutions enough room to implement the regulation in a way that fits their needs and business model. Indeed, if a number of technical requirements, guidelines and principles have yet to be released (end of 2015), it is expected that no specific tools or formalized methods will be imposed.

The French approach to this issue is rather based on setting minimum risk reporting requirements for all relevant actors that incentivize them to better assess climate-related risks. To facilitate this process for all financial institutions, the State will provide a baseline for actors to assess their potential exposure and contribution to the energy transition through the National Low-Carbon Strategy. For banks, the State will also assess how to address climate-related risks through stress testing. The main focus thus aims at pushing financial institutions to put these issues on the radar and to adequately price climate-related risks.

This approach does not dictate methodological or procedural choices. Reporting requirements will most likely take the form of minimum requirements, leaving voluntary institutions to implement more advanced strategies if so desired. Thus institutions would be free to find the methods of compliance in line with their business model – which can favour the emergence of a range of best practices.

The French State's use of a supervision-oriented approach rather than additional regulation is similar to what can be observed internationally whether at the international level (with the Financial Stability Board), at the national level (such as in the United Kingdom with Bank of England's initiative targeting the insurance industry) or at the individual level (such as the Norwegian Sovereign Fund reviewing its portfolio in the light of climate-related risks).

BUILDING ON THE FRENCH EXPERIENCE BY UNDERSTANDING THE BROADER DYNAMICS

The recent regulations specifically addressing climate change are the most recent chapter in a longer story. The laws improving the integration of sustainability issues in the financial sector – Grenelle II Law in 2010 and ETGG Law in 2015 – both resulted from structured, fostered discussions gathering a broad range of stakeholders over multiple months. These 'Grenelle-type' discussions enabled institutions and individuals to structure their knowledge on sustainability or climate-energy issues and to raise awareness all the way up to top management.

Most recently, COP21 has opened several windows of opportunity to advance the sustainability agenda based on existing dynamics and expertise throughout the ecosystem. The development of this broader expertise is the result of over fifteen to twenty years of progress made by financial institutions and market actors on Socially Responsible Investment, ESG integration and the advocacy by non-profit experts. Throughout this process, interactions and dialogue between all stakeholders have been a critical part of fostering the appropriation of the sustainability issues at stake.

NEXT STEPS AND CHALLENGES COMING AHEAD: KEEPING THE DYNAMIC ALIVE IN A POST-COP21 CONTEXT

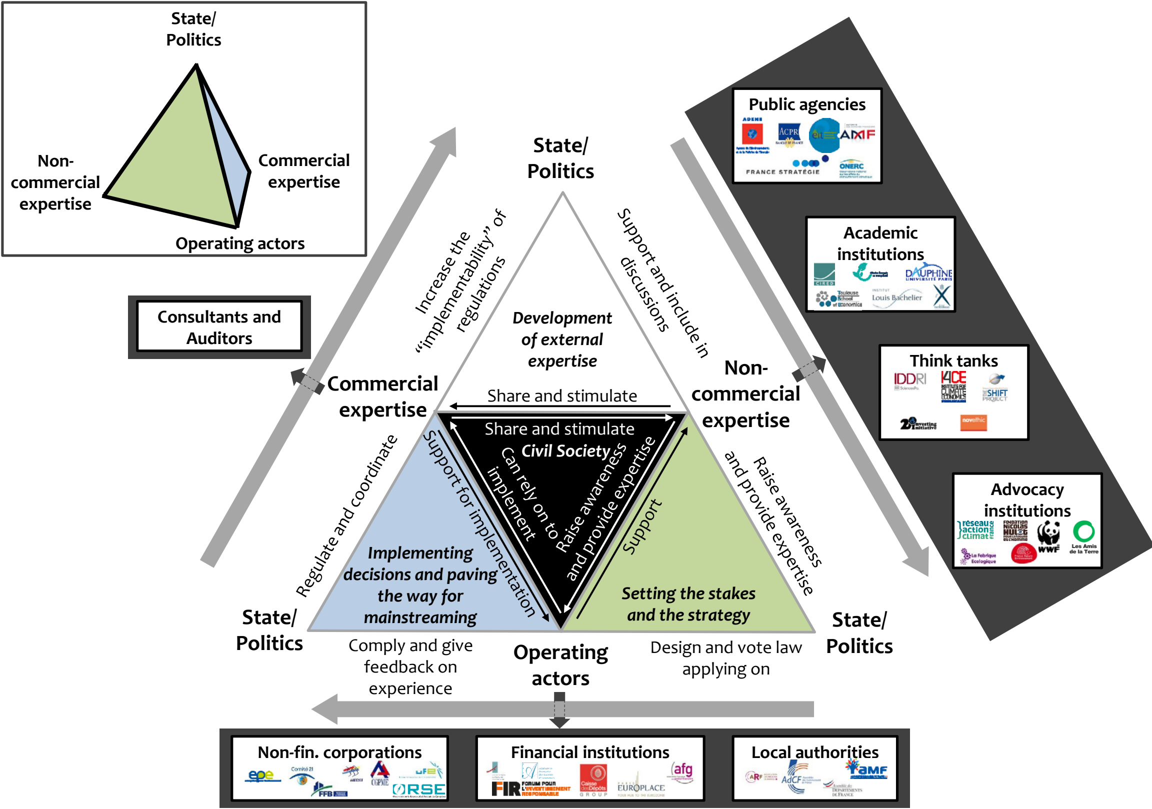
The next steps and challenges ahead for the French ecosystem are threefold:

First, the methodologies and tools necessary to fully implement the EETG law requirements are still emerging. Overcoming the technical challenges to apply the reporting requirements adequately implies finding ways to define indicative climate financing targets for institutions. To be feasible in practice, this must be partially based on existing tools and available data. The capacity of different stakeholders to facilitate the development of the relevant tools will be therefore crucial as the capacity of financial institutions to appropriate the reporting framework improves gradually.

Second, the implementation of the EETG legislation will consist of both hard and soft laws. Therefore, the compliance of financial actors will take a supervision-oriented approach rather than additional regulation. This implies that the reporting process must be in and of itself useful for institutions – and the risks covered are seen as material. Approaching actors through risk, whether financial or reputational, is a way to make the financial system fully play its fundamental role. However, on the one hand, the appropriate pricing of associated risks implies ensuring the emergence of a broader economic context where externalities are priced explicitly or implicitly by regulatory frameworks – such as direct or indirect carbon pricing. Clear signals by governments on future sustainability-related policy can ensure that they are seen as material. On the other hand, reputational risks can also increase the materiality of climate- and sustainability-related topics, thus implying that follow-up on the implementation of both hard and soft rules will be crucial to enhance their impact – whether done by supervisory institutions, professional associations or non-profit organisations.

Finally, these dynamics may be supported by the third challenge: being able to share practices both internationally and at the European level. Discussions have turned to the value and pathways of expanding certain reporting frameworks – including Article 173 of the EETG Law – to other countries at the European level. The ongoing discussions at the EU level around the "Capital Markets Union" has been specifically identified by several financial institutions as potentially the most rapid and relevant way to implement at the EU level regulation that improve the integration of sustainability issues into the financial sector. Furthermore, the recent development at the FSB is encouraging and France could share its experience to help other countries improve the integration of sustainability in their respective financial sectors.

Architecture of the French ecosystem regarding the expertise on sustainability issues



Note: the list of institutions is for illustrative purposes only and does not show all actors active in France. The authors intentionally do not cite any individual commercial entities in order to avoid passive promotion.

Source: I4CE

INTRODUCTION

The UNEP Inquiry has been tasked over a two-year period to work with financial system actors to understand what steps can be taken to support the emergence of sustainable economic and social models. In the run-up to the 21st Conference of the Parties of the UNFCCC (COP21) in Paris in December 2015, an important emphasis has been placed on how the financial sector takes into consideration and contributes to overcoming the challenges posed by climate change. This report draws from evolutions in the French financial sector over the last two decades to inform the broader international discussions. The principal focus of this study is the integration of sustainability issues by financial institutions. Climate-related[1] issues are nevertheless prominent given the current level of attention around the world – as well as the recent Law on Energy Transition for Green Growth in France.

During the Climate Finance Day in Paris on 22 May 2015, the French government announced the adoption of climate-related reporting requirements: non-financial corporations and financial institutions must evaluate and report on their exposure to climate-related risks as well as on the business impact of climate change developments and the low-carbon transition. While a substantial step towards the integration of climate-related issues in the financial sector, it should be seen in context as just one of many measures to improve sustainability as France has implemented over the last two decades a progressive framework of regulations focusing on reporting but addressing the other means of action.

This report is complementary to the forthcoming 2° Investing Initiative and UNEP Inquiry report on the broader European context. Indeed, the French financial system is dependent on overarching EU-level dynamics – but is also in a position to both inspire and influence EU financial regulation and practice. Further development at the EU level could therefore build on the French experience.

This report first sketches the broad picture of the financial sector in France and how it contributes to financing the 'real economy' with a focus on the low-carbon transition. The second section describes specific regulations and initiatives that have been implemented to integrate sustainability in the financial sector. This mix of hard and soft rules and institutionalized practices has led to the emergence of a unique ecosystem of actors. Using the analysis framework developed by the UNEP Inquiry, this overview of the French sustainability landscape addresses transparency and disclosure, capital mobilization, risk assessment and financial culture. Finally, the discussion focuses on challenges the ecosystem of actors will be facing, particularly with the implementation of the new regulation.

[1] The terms 'climate-related' refers to both the impact of climate change as well as the policies put into place in the fight against climate. As such, climate-related risks includes both climate and carbon risks.

1 UNDERSTANDING THE FRENCH FINANCIAL SYSTEM

Key Messages

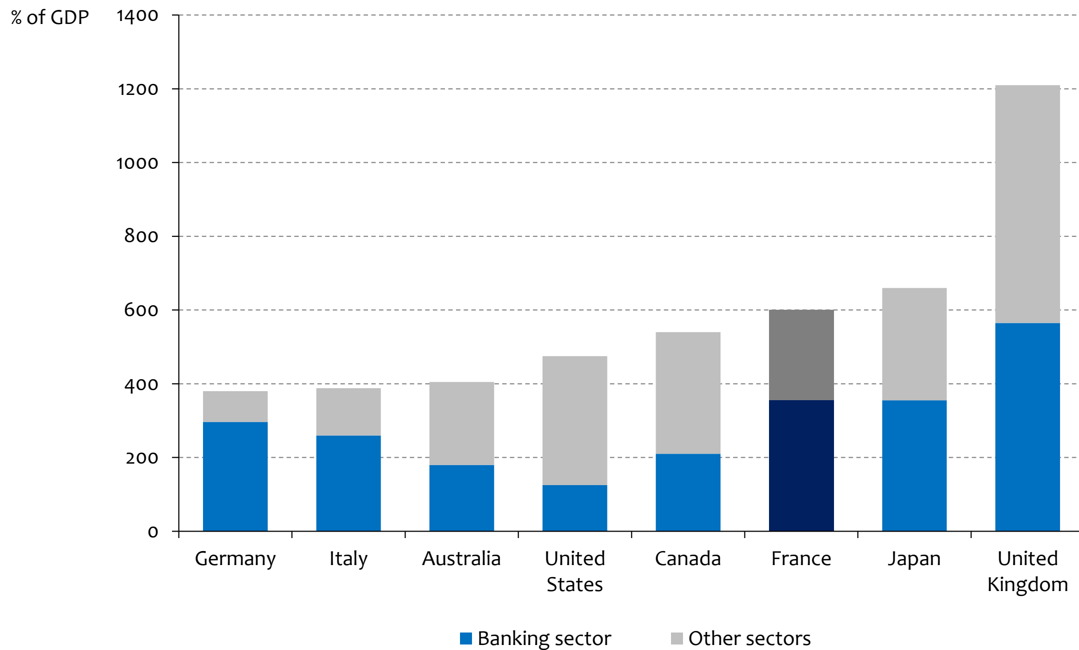
- While markets provide an increasing share of financing for large companies, banks play an important role in the financing of households and SMEs. The operating context of banks has evolved post-crisis with prudential rules tightening their capacity to provide loans.
- The allocation of French households' savings is diverse, with large holdings in the form of life insurance and a smaller – but still significant – portion placed in regulated savings accounts with high-value individuals increasingly entrusting funds to the asset management industry. Therefore, a significant share does not end up on the balance sheet of banks.
- The French economy and financial system is integrated internationally: large companies and banks routinely access international markets while a significant part of households' savings are invested abroad.
- The French context of financing the energy transition is encouraging as more than 1% of GDP is channelled each year to 'climate' investments.

According to the IMF (2012), "*France's financial system is large, sophisticated, and integrated both vertically and internationally*". While a full description is beyond the scope of this short report, particularly if the links with financial systems in other countries are taken into consideration,[2] this report presents key characteristics through a short review of the French financial system, and more specifically its role in financing the French 'real economy'. The analysis presented here first focuses on the institutions financing non-financial corporations and households; and second, how deposits and savings are collected and leveraged by different institutions.

France's financial system totals approximately €12 trillion of assets, or roughly six times France's annual GDP. The nation's financial balance sheet is dominated by assets held by credit institutions – around €8 trillion. Compared with other OECD countries, the relative size compared to GDP of the French financial system's balance sheet is among the largest, but not an outlier (Figure 1).

[2] While beyond the scope of this study, it should be noted that international flows are important to take into consideration given that the French financial system finances actors outside of France and vice versa.

FIGURE 1 – AVERAGE SIZE OF FINANCIAL SECTOR ASSETS, AS % OF GDP OVER THE PERIOD 2012-2013



Source: IMF

1.1 THE ROLE OF DIFFERENT FINANCIAL INSTITUTIONS IN FRANCE

Historically, the banking sector has and continues to play a key role in financing the French economy. However, following the 2008 financial crisis some evolutions are noticeable. The macrofinancial context and the strengthening of the prudential environment have prompted the various financial institutions to reconsider their respective role. This has led to an increase in the involvement of institutional investors in financing of companies, with banks refocusing their activities on core areas where they hold clear advantages.

This section presents the structure of French financial institutions (Sections 1.1.1 and 1.1.2); how these institutions currently finance the economy (Section 1.1.3); and how they themselves are financed – with a focus on how national savings are leveraged (Section 1.1.4).

1.1.1 THE FRENCH MODEL OF 'UNIVERSAL BANKING'

The French banking system is often characterized as a 'universal banking' system. This term refers to the provision of financial services by banks to a variety of clients – households as well as small and large companies. This requires a combination of both retail banking and corporate and investment banking (CIB) services – and in some case an insurance subsidiary. This client-oriented strategy has contributed to the traditionally high reliance on wholesale funding of French banks to finance their activities.

This reliance on wholesale funding has enabled French banks to have a high leverage ratio (IMF, 2012), which has, however, markedly decreased since 2008 (Figure 2). While overall outstanding loans to French households and companies did not contract over the crisis (in contrast with trends elsewhere in Europe), French banks actively rebalanced their funding structure. They have substantially increased their capital base and rebalanced their funding models to adjust to the new prudential requirements: Basel II.5, Basel III, and in EU legislation, CRD3 and CRD4. Therefore, in order to reduce their US$ wholesale funding and adapt to prudential rules that are more stringent, they have also selectively disengaged from international CIB activities.

Figure 2 – Comparative evolution of loans and resources of French banks

Source: ACPR (2014) based on ACPR and CDC data

French banks have several well-known unique features, including their expertise in various domains such as equity derivatives and project finance. For instance, according to IJGlobal, three major French banks are among the ten leading banks in project finance worldwide.[3] France is also the only European country with a majority (60%) of deposits and loans managed by cooperative banks – i.e. those owned by their customers.

French banks also implement a strict separation of proprietary trading activities from other core banking services, which, for now, is the principal difference between financial regulations in France and in the EU (see Box 1).

Box 1: The recent law on the separation and regulation of banking activities is the main source of difference between French and EU regulations

France adopted in 2013 the Separation and Regulation of Banking Activities Act (Ministère de l'économie, 2013). The main rules deal with the separation of core banking activities and proprietary trading activities. It requires banks to create dedicated subsidiaries to operate trading activities identified by the supervisor as prop-trading. It is estimated that the definition of activities to be separated covers 3 to 5% of current CIB activities – up to 10% on a pre-crisis basis. Specific regulations on agricultural commodity-related trading activities and market making activities were also implemented.

This law strengthened the macroprudential oversight of the financial system and sets new rules on bonuses and wages. A specific part of the law focuses on money laundering and tax evasion by requiring mandatory reporting of a bank's activities per country.

Following the EU Liikanen Report on banking supervision,[4] similar regulation at the EU level is currently under discussion (European Council, 2015).

[3] Crédit Agricole, BNP Paribas and Société Générale.

[4] This report followed the Dodd-Franck Act in the US and the Vickers Commission in the UK.

1.1.2 French insurance companies and asset managers

The French insurance industry is large and represents a balance sheet of €2.3 trillion. French insurance companies invest mainly in securities. In order to fulfill liquidity needs, a large part (73%) of this investment takes the form of debt securities, including €290 billion in French government debt, €325 billion of securities issued by French banks and a little less than €50 billion of corporate bonds. The remainder is composed of quoted and non-quoted stocks and real-estate. (ACPR, 2015)

While less a focus of French households, the financial asset managers in France manages upwards of €3.2 trillion in 2014 – up from €1.4 trillion in 2000. This total is almost evenly split between funds structured under French law and funds under international legal regimes or mandates. Of this, approximately €400 billion is entrusted to French managers from foreign asset owners. Over 630 portfolio management companies are active in France, with the number increasing by 200 over the last five years. A number of these are also global actors with four French groups – Amundi, Natixis Global Asset Management, AXA Investment Managers and BNP Paribas Investment Partners – among the largest twenty asset managers in the world. In terms of its position vis-à-vis other European countries, France is third behind the UK and Germany in terms of where financial management actually occurs (physical address of asset managers) and equally third in terms of the legal address of funds themselves – behind Luxembourg and Ireland.

Asset managers play an increasing role in financing the economy. In 2014, French asset managers held close to €1.4 trillion in corporate and close to €750 billion in public stocks and bonds. They appear to have a national bias with half of their investments in stocks and 40% of investment in bonds from French economic actors. There has also been a tendency to invest bonds from non-finance sector companies, moving from 20% to 40%. Therefore, €900 billion out of the €3.2 trillion is invested in French companies (AFG, 2015).

1.1.3 How is the French 'real economy' financed?

1.1.3.1 The banking sector plays a predominant role in the debt financing of private non-financial actors

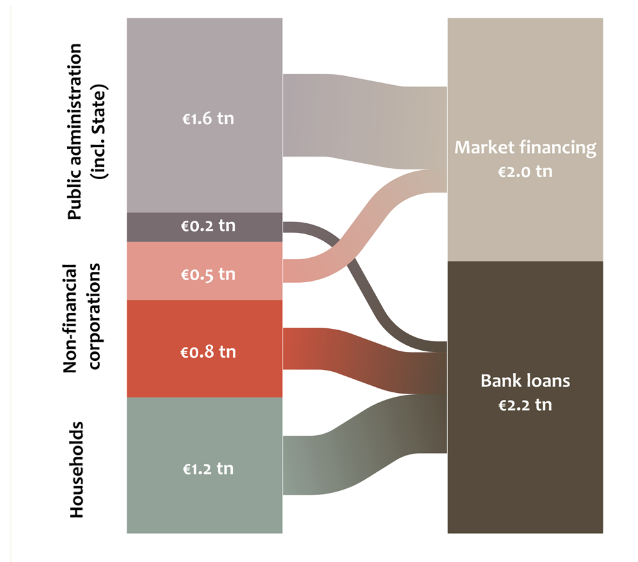
Non-financial economic actors in France can be divided into three categories: households, non-financial corporations (NFCs), and the public sector (excluding public financial institutions). Together, these entities hold more than €4 trillion in outstanding debt. This debt is made up of debt securities (e.g. bonds) and bank loans (Figure 3).

Publicly held debt represents about 75% of market financing, with debt securities issued by the French central government and related agencies accounting for 90% of market financing dedicated to public institutions. The portion of bonds issued by private non-financial actors is smaller – €0.5 trillion of outstanding debt securities. Moreover, financial markets play an important role in refinancing although this report does not look at this in detail.

Conversely, banks finance essentially 100% of debt contracted by households and about 65% of NFC debt. As a consequence, banks play a pivotal role in financing most of the non-financial actors – i.e. the 'real economy' – especially households and SMEs.

An assessment of debt issuance and outstanding amounts suggests that while French non-financial actors have not increased their recourse to debt financing, some changes are nevertheless noticeable over the past years.

FIGURE 3 – OUTSTANDING DEBT OF FRANCE'S NON-FINANCIAL ACTORS BY ASSET TYPE, AS OF 31 DECEMBER 2013

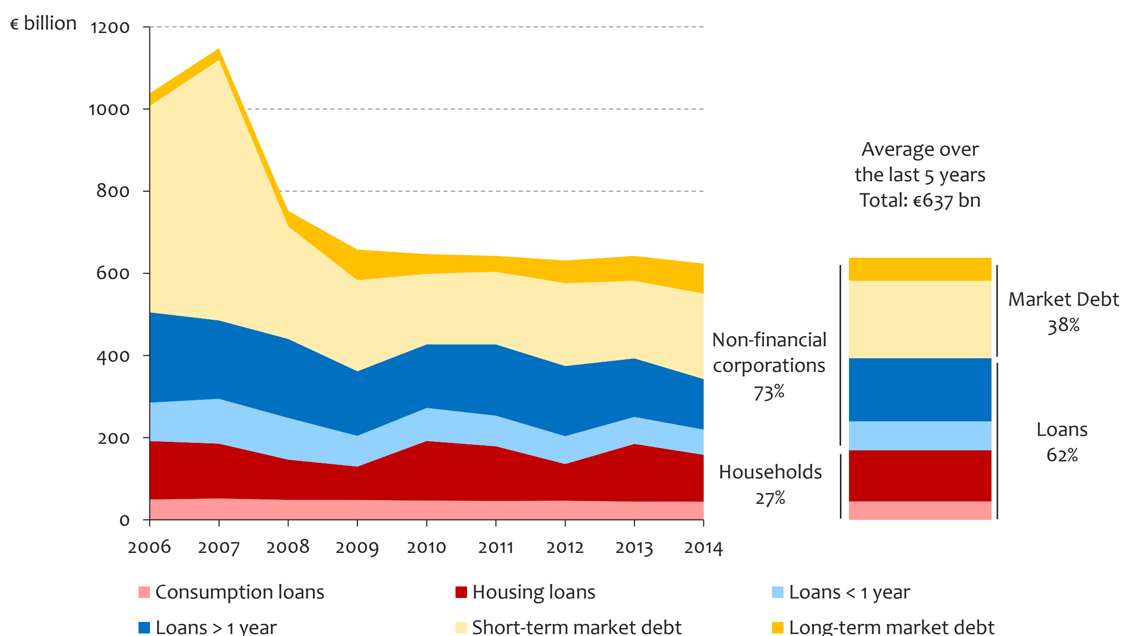


Source: Banque de France

Two dynamics can be noted: first, while the total value of outstanding market debt and bank loans has increased since 2009, the annual volume of new debt has remained relatively constant and average maturity has increased (Figure 4).

Second, since 2009, a slight shift has been observed as the share of bank lending in NFCs debt financing has decreased on the back of a sharp increase in the use of market debt, particularly through long-term instruments. From the perspective of banks' balance sheet, mortgage activity remained relatively steady. This evolution has tended, in general, to increase the average maturity of banking book portfolios.

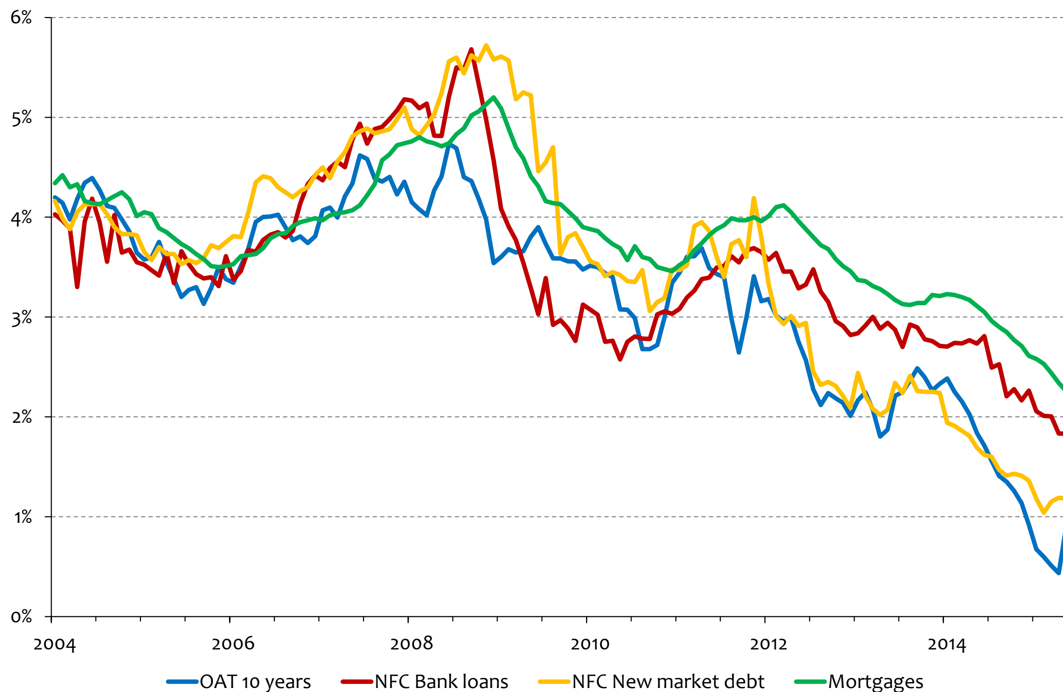
FIGURE 4 – ANNUAL GROSS VOLUME OF NEW ISSUED DEBT IN FRANCE BY HOUSEHOLDS AND NFCS (2006-2014)



Source: Banque de France and European Central Bank

Regarding financing conditions, interest rates have substantially decreased since 2008 and have now reached historically low levels (Figure 5). Low spreads (consistently below 100 bps, and often below 50 bps compared with 10-year French government bonds since 2009) can explain the increasing use of long-term market debt.

FIGURE 5 – INTEREST RATES BY TYPE OF DEBT IN FRANCE (2004-2014)



Note: NFC bank loans over €1 million over 1 year. Long-term mortgages.

Source: Banque de France

French economic actors continue to have access to financing at low interest rates, among the most advantageous in the EU. More broadly, conditions of access to credit in France tend to be better in practice than how they are perceived (ECB, 2015). For Villeroy de Galhau (2015), this contradiction is due to a misunderstanding between banks and NFCs, specifically after the short period of credit restriction in 2008-2009.

Overall, French economic actors benefited from almost continuous access to finance at low interest rates. Contrary to other European economies, the French economy did not go through a macrocredit crunch. Nevertheless, given the pivotal role of banks in financing households and SMEs, the supply of credit is subject to careful monitoring by stakeholders, for example through the government-mandated *Observatoire du financement des entreprises.* Furthermore, public authorities use various means– such as Bpifrance – to address structural and temporary credit constraints.

1.1.3.2 AN IMPORTANT PRIVATE EQUITY INDUSTRY ALTHOUGH RECOURSE REMAINS UNEQUAL

While attention is often focused on debt financing, equity investment also plays a critical role. The private equity industry is well developed in France with more than €7 trillion raised in 2014 – the second largest volume in Europe. On venture capital, France is the third largest player in Europe in volume and remains in the average compared to GDP.

In the last decade, French SMEs increased their financing from both equity investment and debt products – while the former increased faster. However, this appears to be largely a side effect of increased retained earnings (Berger and Lefebvre, 2013).

In terms of equity volumes, however, French SMEs have good access to external equity resources compared with other European countries. However, this must be nuanced depending on their stage of development. Capital investments remain limited for the early 'seed stage' of development as well as for investments over €100,000 (Berger and Lefebvre, 2013; Villeroy de Galhau, 2015). Tackling this observed gap in the availability of equity investment is one of Bpifrance's missions (see Section 3.2.1).

Finally, the access of French SMEs to private equity, while imperfect, is well above the European average. The Berger and Lefebvre report to the Prime Minister on improving the leveraging of French household savings (2013) has recommended the development of new life insurance products to further expand the access of French SMEs to private equity.

1.1.4 Role of French savings in the financial system

1.1.4.1 *Households savings are mostly placed outside of the banking sector*

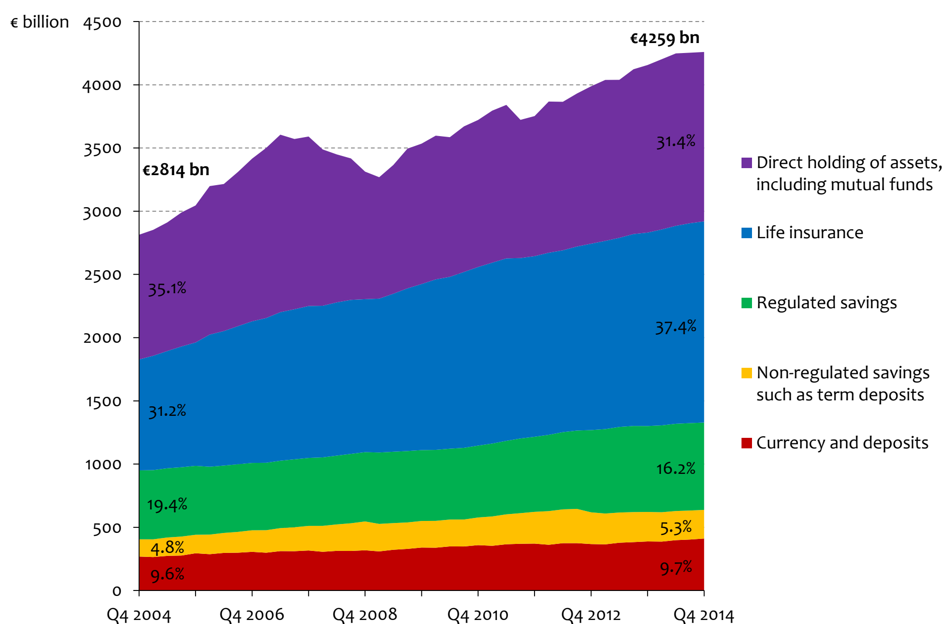
Households benefit from numerous fiscal incentives linked to various savings instruments. Discussions around different savings instruments focus on long-term saving with wealth inequality receiving careful attention. For example, fiscal incentives are used to support savings through instruments accessible to all types of depositor to incentivize the development of long-term savings with a minimum holding period or to target investment in SME equity. This section does not discuss in detail the rationale behind these savings products and fiscal incentives, but rather provides a short overview of the current system to better understand how private savings are allocated and contribute to financing the economy.

French households' savings can be classified in five major categories:

- Direct investment in financial assets, including mutual funds shares and unlisted equity
- Life insurance products
- Regulated savings accounts such as *Livret A, Livret Développement Durable (LDD), Plan d'Épargne Logement (PEL), Livret d'Épargne Populaire (LEP), etc.*
- Non-regulated savings accounts
- Currency and deposits

The distribution of savings between these categories is illustrated in Figure 6. Evolutions in this distribution have a significant impact on the banking system and their role in financing the economy. While banks provide 80% of households and NFCs' loans, only a minor part of the French savings remains on the balance sheet of these institutions due to how life insurance and regulated savings are managed.[5]

Figure 6 – Developments in financial investment by households



Source: Banque de France

[5] To have a more comprehensive overview of the links between saving products, tax system and the financing of the real economy, see following reports: 2° Investing Initiative with France Stratégie (*forthcoming*), Berger and Lefebvre (2013), HCSF (2015) and COREFRIS (2011)

1.1.4.2 *Life insurance*

Life insurance products account for more than a third of household savings. While life insurance products currently offer higher interest rates than savings products offered by banks, their broader success is mainly explained by both intrinsic flexibility of the product and specific fiscal treatment. These products have the double advantage of a specific tax exemption status on interest and dividends depending on the length of holding, combined with special regulations for inheritance taxes.

Historically, banks have collected through subsidiaries more than half of the savings placed in life insurance products. However, as banks are considered to be only intermediaries, these amounts do not end up on their balance sheets. Therefore, given the importance of on-balance sheet capital from a prudential perspective, the savings entrusted to their management through life insurance products do not directly contribute to the refinancing of their lending activities. Furthermore, life insurance funds are principally invested in securities – particularly bonds and to a lesser extent, stocks, including those of financial institutions (OER, 2015). As such, insurance companies are important market investors and manage most of the exposure of French households to financial markets.

1.1.4.3 *Regulated savings*

Regulated savings accounts are guaranteed-capital instruments that allow all depositors to put a capped amount – €22,950 per person for the *Livret A* – into a savings account with a tax-free interest rate set by the government based on a predetermined formula – 0.75% since August 2015. Around 60% of funds raised by the Livret A, LDD and LEP are centralized in a public trust – the *Fonds d'Épargne* – managed by the Caisse des Dépôts (CDC)[6] – totalling today around €250 billion and mainly devoted to finance social housing (including renovation) and other local development projects. The remaining 40% of the funds raised through regulated savings are managed by banks and directly included on banks' balance sheets.

The CDC and the *Fonds d'Épargne* typically use these funds to provide low-cost long-term financing to local governments for infrastructure and other projects in the public interest. As there is no time limit on when depositors can withdraw their funds from these accounts, the CDC uses the remaining portion to ensure liquidity through investments in easily exchangeable financial assets (liquidity portfolio). This currently accounts for roughly 40% of the portfolio. In terms of the integration of sustainability issues, the allocation strategy of the centralized funds typically follows CDC policies (see Section 3.2.1). Recently, the CDC implemented favourable credit conditions for green projects in local development.

The use of regulated savings remaining on banks' balance sheet focuses principally on SMEs and energy efficiency retrofitting projects. While banks currently report on the use of funds to finance SMEs, they declare to be unable to report the financing of retrofitting operations as the relevant statistics cannot be separated from other building and mortgage operations in their statistics (OER, 2015). This is notable given that in the case of the *Livret Développement Durable*,[7] sustainability is marketed to consumers as a key part of its management strategy.

1.2 Estimating financial flows contributing to GHG mitigation and the energy transition: the French climate finance landscape

Evaluating how the financial system is contributing to a sustainable economic model can be challenging as linking finance and investment in the real economy requires extensive data. France is one of the few countries to have a transparent and comprehensive vision of domestic climate finance flows.[8] I4CE-

[6] Further details on the CDC are given in Section 2.2.1

[7] As described above, LDD stands for *Livret Développement Durable*, literally "Sustainable Development savings book".

[8] Climate Policy Initiative has produced country-level assessments for Germany (2012) and public finance in Indonesia (2014).

Institute for Climate Economics (former CDC Climat Research) released a public and private climate finance landscape focusing on domestic flows in France in 2011 (see I4CE, 2014) and for the period 2011-2014 (I4CE, 2015). This exercise has mapped identifiable direct capital mobilization leading to tangible investments that contribute to GHG mitigation in France. The study also presents how these investments were financed, which instruments were used and what role different institutions played.

The usefulness and potential importance of this type of tracking has been demonstrated in the requirement set by Article 174 of the 2015 Law on Energy Transition for Green Growth that the French State tracks and reports annually on public and private financial flows dedicated to the energy transition as part of the annual budget process. While able to give a snapshot of direct capital mobilization, this approach has nevertheless two principal limitations: firstly, it does not capture the refinancing challenge of the green economy; second, it cannot on its own readily capture whether mobilized capital represents additional investment or the redirecting of investment flows from carbon-intensive to low-carbon investments. Indeed, various studies indicate that the main challenge regarding the financing of the low-carbon transition is the redirection of investments rather than the mobilization of additional resources.

1.2.1 Climate finance flows in France are on track and future scaling-up seems manageable

I4CE's study indicates that climate investments totalled between €30 billion in France in 2011 and approximately €36 billion in 2013.[9] Such flows represent from 1% to 1.5% of France's GDP and 10% of its tangible investments.

In 2011, a balance was noted between renewable energy and energy efficiency investment (Figure 7). The three main categories of projects – namely energy efficiency, renewable energy and transport infrastructure – were spread across different economic sectors. However, the buildings sector concentrates almost half of climate finance in France (Figure 7), whether for new renewable energy capacity or energy efficiency.

Results for 2011-2014 suggest an annual convergence of French climate finance investments at 1.5% of GDP (I4CE, 2015).[10] Furthermore, these results indicate that the balance has tilted in favour of energy efficiency investments with the building sector making up the principal recipient of investment between the different economic sectors.

Overall, the substantial climate finance flows identified by I4CE's work are closer to the estimated financing needs than initially expected. Indeed, the French national debate on energy transition estimated all energy investments[11] needs between €40 and 60 billion per year. As the scope of energy investments is much larger than the scope of I4CE's study, it indicates that the investment gap in the coming years is nevertheless manageable if the appropriate actions are taken.

1.2.2 A critical role for the private sector with public support principally taking the form of subsidies

Regarding how these operations were financed, private actors provided the financing for 85% of renewable energy and energy efficiency investments.[12] In the transport sector, the picture is less clear

[9] This range is principally dependent on how eligible transport infrastructure and nuclear power generation are defined.

[10] I4CE, in partnership with the French Energy Agency ADEME and the Ministry of the Environment, is updating these results for the period 2011-2014. This update due at the end of 2015 will improve the robustness of the analysis and allow comparison of figures between years.

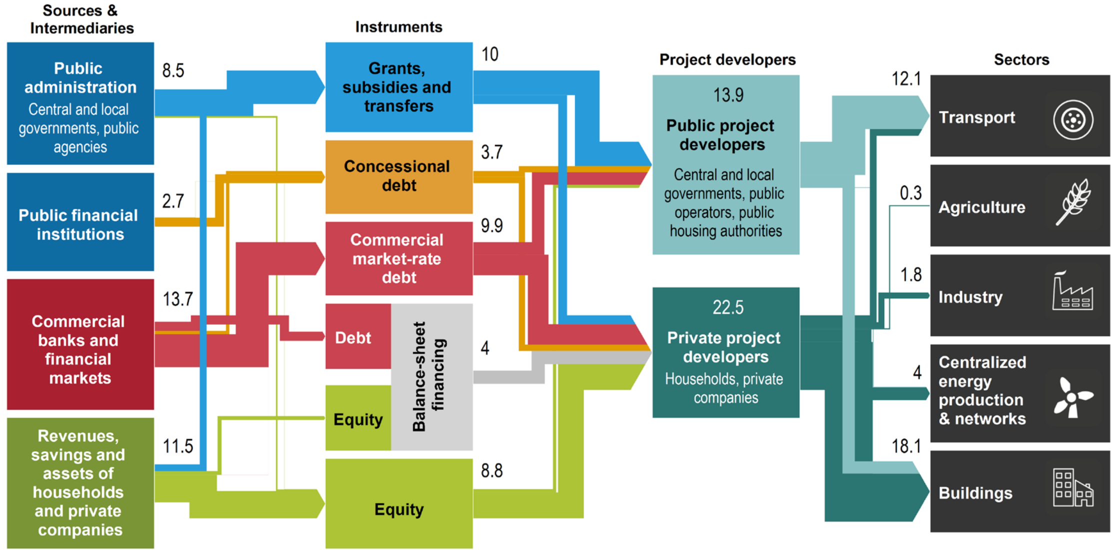
[11] 'All energy investments' refer to all investments related with energy production or consumption. On the other hand, low-carbon investments are those mainly focusing on energy efficiency, renewable energy and sustainable infrastructure.

[12] The study focuses on capital expenditure. Therefore, it does not take into account feed-in tariffs. The next iteration of the report will estimate and incorporate the level of feed-in tariff support.

as projects are initiated principally by public bodies with financing provided – through bank loans and bonds – in part by private actors.

Nevertheless, the public sector is playing a larger role in supporting climate-related investment than its share of total investment in the economy. In 2013, 51% of total financial flows depended upon public action, whether in the form of direct public investments from State and local governments and public institutions, public grants and subsidies to project developers, orienting concessional debt towards specific beneficiaries or a small amount of other financing support mechanisms for project developers. The role played by the public sector in climate finance is twofold: first, the 'greening' of traditional uses of public finance in France, such as support for public housing, for home ownership or investment in urban public transportation; second, public incentives to reorient private finance to support a low-carbon economy and the energy transition – this form of public support represented €3.9 billion in 2013.

Figure 7 – Simplified overview of climate finance flows in France in 2013



Source: I4CE (2015)

The role of financial institutions is central in the mobilization of climate capital. The capacity of the financial system to finance the transition appears sufficient when looking at the amounts at stake. With that perspective, it is critical to ensure that the private financial sector efficiently channels sufficient capital towards investments supporting – or at least not inhibiting – the transition at adequate pricing conditions.

2 THE EMERGENCE OF AN ECOSYSTEM IMPROVING THE INTEGRATION OF SUSTAINABILITY ISSUES INTO THE FINANCIAL SECTOR: AN ACCELERATION SINCE THE 2000s

Key Messages

- In the past fifteen to twenty years, France has seen the emergence of an ecosystem of actors with an increasing level of expertise on sustainability issues. The development of Socially Responsible Investment (SRI) and the integration of Environmental, Social and Governance (ESG) criteria across the financial sector began in the 90s as well-established actors developed then-niche approaches to these issues. These developments often mirrored the concurrent integration of ESG and broader sustainability awareness among companies and the corporate sector.

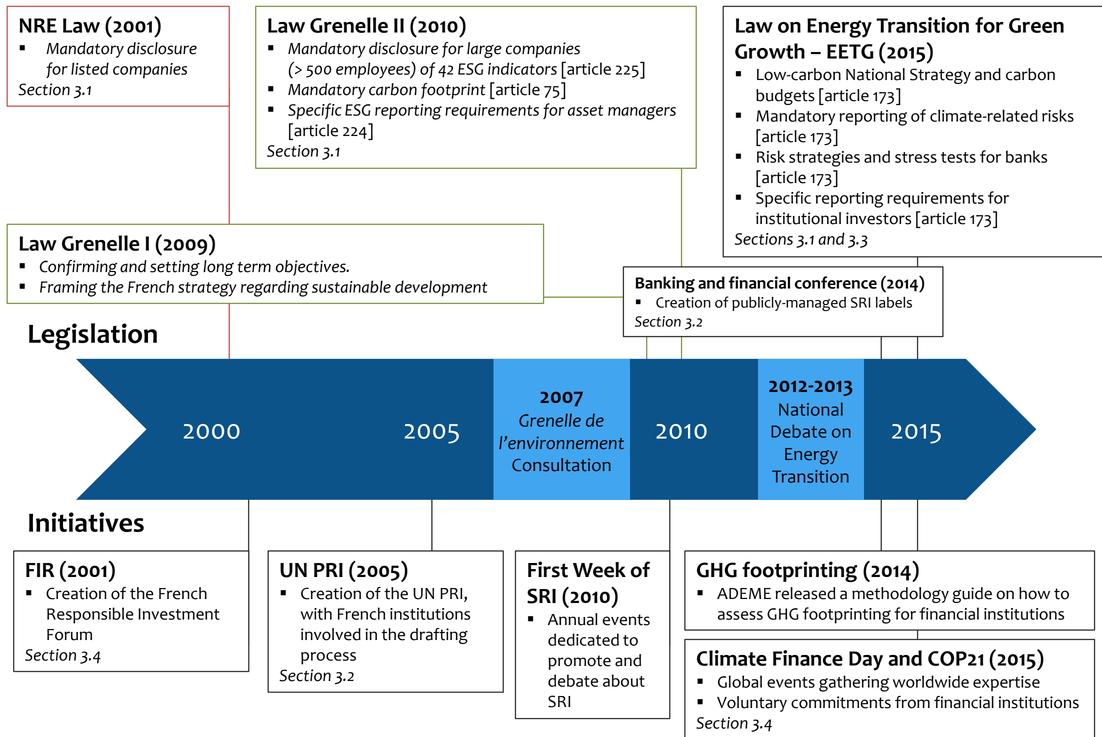
- The origins of these dynamics can be linked to a number of simultaneous individual and collective initiatives and the implementation of new regulatory frameworks by the French government.

The origins of the integration of sustainability issues by financial institutions in France can be tracked back to before 2000. However, the first laws directly addressing the integration and disclosure of extra-financial issues were enacted after 2000 (see Figure 8). As explored below, two key parts of this process have been the emergence of the dynamics around Socially Responsible Investment and the integration of Environment, Social and Governance issues. Most recently, since 2010 and the Law Grenelle II, attention has increasingly focused on climate and energy issues. This has accelerated within the financial sector over the past two years in the run up to the adoption of the Law on Energy Transition for Green Growth (ETGG, 2015) and COP21 in December 2015.

These dynamics have led to the emergence of an increasingly robust ecosystem of institutions and actors with strong expertise on sustainability issues.

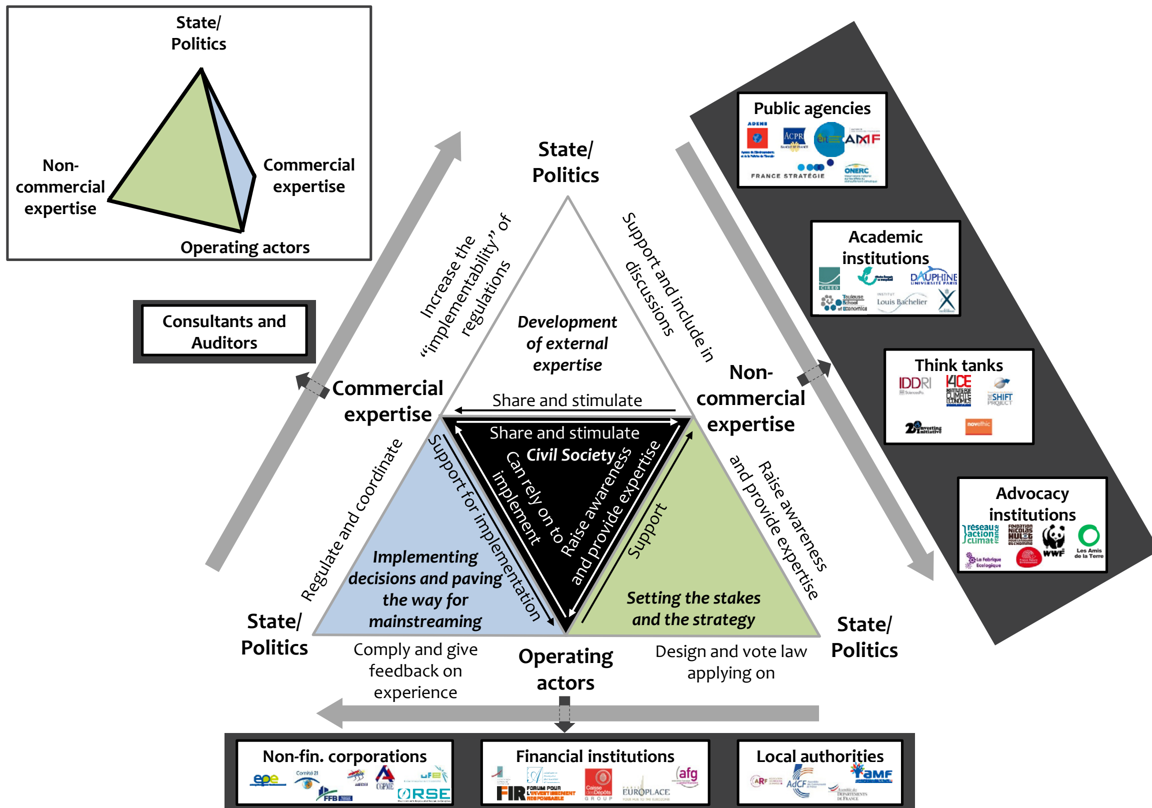
Today, this 'French ecosystem' appears to carefully balance financial and non-financial objectives and priorities. While the level of development and integration is not consistent across sustainability topics, it nevertheless appears that climate- and more broadly sustainability-related financial issues are comparatively more present in the French financial ecosystem than in other countries.

Figure 8 – Timeline of sustainability initiatives and legislation in France



Source: I4CE

Figure 9 – Architecture of the French ecosystem regarding the expertise on sustainability issues



Note: the list of institutions is for illustrative purposes only and does not show all actors active in France. The authors intentionally do not cite any individual commercial entities in order to avoid passive promotion.

Source: I4CE

The current structure of the French financial ecosystem is presented in Figure 9 and represented by a triangular pyramid. At the apex of the pyramid is the State and, more broadly, different instances where regulatory decisions are made. The other three corners of the pyramid are occupied by:

- Public and private financial operators impacted by policies;
- Non-profit experts, including state agencies, academic institutions, think tanks and advocacy NGOs;
- Commercial actors and experts that assist companies with compliance with regulation and policy (generally consultants and auditors);

On each face and edge of this pyramid, the dynamics can be complex as the give and take between actors is negotiated. As such, the careful balance that has emerged between financial and sustainability issues can at times be fragile. All actors have a role and if one of them was weak or not present, the whole pyramid would be weakened. The following section presents an overview of how this sustainability-friendly financial ecosystem has emerged. Section 4 then presents the challenges it will likely face in the coming years.

2.1 Understanding the emergence of SRI to better understand the ecosystem's dynamics

The demand in France for improved extra-financial information accelerated in the early 2000s as seen in many financial markets worldwide. In France, this increased awareness led to the creation in 2001 of the Responsible Investment Forum (FIR), bringing together interested institutions, commercial actors and non-profit experts. This ecosystem of actors grew rapidly after the adoption in 2005-2006 of SRI strategies by two major investors – ERAFP[13] and FRR[14], both public institutions – which ultimately led to the development of similar strategies by more than one hundred other financial institutions. The role of the labour unions present on the boards of these two institutions is often seen as a key factor. Indeed, unions widely insisted that SRI strategies should be implemented to improve coherence with the interests of beneficiaries. Therefore, asset managers started to design and offer SRI products with expectation of informal and formal mandates to address this topic from institutional investors. This in many ways explains why some major French asset managers are comparatively more advanced on climate- and sustainability-related issues. In 2010, Article 224 of the Grenelle II law furthered this evolution with mandatory ESG reporting for asset managers (see Section 3.3.2).

The financial crisis in 2008 and the lack of new major institutional investors implementing SRI strategies led to a market restructuring. This occurred simultaneously to the implementation of the Novethic SRI label (see Section 3.2.2) and the development of deeper expertise, particularly by investors, analysts and asset managers. Transparency increased, and so did the depth of expertise – whether academic or operational – on the benefits and impacts of improved integration of SRI criteria. At the same time, one can observe an increased attention to the integration of ESG approaches[15] – and thus a more risk- and profit-based focus. Nevertheless, if ESG integration can be seen as a way to improve and confirm the relevance of SRI approaches, it can lead sometimes to less ambitious strategies and policies.

Most recently, SRI and climate-related investment issues are seen as clearly linked. In a survey of financial actors, Novethic (2015) found in September 2015 that climate change has become the most visible SRI topic discussed, bringing together parts of the climate and finance communities. Similar to the subsequent emergence of ESG following SRI integration, climate-related issues have historically been tackled first through ethics or responsibility-based criteria and now increasingly through risk-based approaches. In

[13] Régime de Retraite Additionnelle de la Fonction publique

[14] Fonds de Réserve des Retraites

[15] ESG integration is the integration of some ESG criteria in mainstream asset management. It is often less binding than SRI as it does not imply a systemic impact on assets.

any case, the issues at stake for both topics are similar: a need of an efficient financial ecosystem to enable the expansion and 'mainstreaming' of minimum shared practice into the financial sector and the broader economy.

2.2 Five years of growing attention to climate issues in the financial sector

Until the early 2010s relatively little attention was paid in France to the role played by financial institutions in financing an economic model incompatible with the 2°C climate objective. Banks and other financial institutions were active in adopting in 2003 the Equator Principles – Crédit Agricole CIB was one of the first ten to do so, followed by many major French banks. While this laid out the integration of ESG criteria in financing decisions on topics related to social and environmental issues, climate change was not one of the main criteria. It also reflects the important role of French banks in project finance.

The Caisse d'Épargne Group was the first in France to attempt to quantify its financed 'scope 3' GHG emissions[16] – or those embodied by their investment portfolios. This stemmed from initial steps between 2007 and 2008 to give environmental ratings to financial products sold in anticipation of an expected regulation on carbon labelling. Both NGOs and the French Environment Agency (ADEME) were involved in the development of the methodology applied. While the labelling project has since been discontinued, advocacy NGOs – principally Friends of the Earth – have used the methodology to rank French banks based on their portfolios. Given the reservations of a number of banks concerning the methodology, this led to one of the first debates in France about the relevance and the means of evaluating financed emissions.

Since then other financial institutions, such as Crédit Agricole, have developed their own methodologies to quantify scope 3 GHG and portfolio emissions. In 2013 and 2014, two reports in France assessed the methods available both in France and internationally. In 2013, 2° Investing Initiative published a report mapping the existing methodologies available internationally for assessing financed emissions (2°ii, 2013). This was followed by a publically-sponsored initiative by the ADEME, in collaboration with ORSE[17] and the Association Bilan Carbone (2014), to develop a report on the available methodologies to assess GHG emissions in the financial sector. This report did not prescribe a specific tool, but rather assessed the pros and cons of existing tools for different types of financial institution and the use-based objective of the resulting quantified data.

Over the past twenty years, France has seen the emergence of an ecosystem of financial actors each playing a role to in the integration of sustainability issues. From SRI, to ESG integration to most recently GHG emissions and related risks, financial operations, commercial experts and non-profit experts have each played a role in facilitating getting sustainability issues on the agenda and moving towards the development of concrete tools to facilitating integration. This is a result of the appropriation of the different issues by actors whether from regulators, business or civil society.

[16] Scope 3 GHG emissions refer to indirect emissions. For the banking sector, their critical component are financed emissions embodied in portfolios.

[17] Observatoire de la Responsabilité Sociétale des Entreprises

3 UNDERSTANDING THE FRENCH APPROACH TO INTEGRATE SUSTAINABILITY IN ITS FINANCIAL SYSTEM

Key Messages

To ensure a wider, more mainstream appropriation in the financial system, French authorities have introduced reporting obligations: first in 2010 for asset managers; and more recently in 2015 for institutional investors.

In practice, this reporting supports three areas of action identified by the UNEP Inquiry as key:

- Risk is addressed through risk disclosure and a better transparency of companies' activity impacts;
- Capital mobilization is addressed with a required reporting of climate-compatible strategies and targeted public intervention;
- Transparency and better information are prerequisites for the development of deeper expertise and the inclusion in general financial culture.

The French State's strategy to mainstreaming sustainability issues can be summarized as nudging actors toward an appropriate recognition and adequate pricing of the risks associated to sustainability factors, recognizing the specificities of the various actors and giving space to institutions to develop both the tools and strategies to implement that best suits their needs and characteristics.

The UNEP Inquiry into the Design of a Sustainable Financial System has set a framework to better understand challenges and solutions for the financial system in the context of sustainable development and the transition to a low-carbon economics model. The global report (UNEP Inquiry, 2015a) detailed a framework of analysis in five key areas: harnessing the public balance sheet, directing finance through policy, transforming culture, upgrading governance and enhancing market practice. Using a different one presented in the 4th progress report (UNEP Inquiry, 2015b), this report examines the landscape of actors, private initiatives and public policy that has driven the emergence of this ecosystem and helped foster capacity building and the acquisition of expertise among sectoral actors: risk management, orderly reallocation of capital, systemic transparency and the financial culture. These four measures are used to understand how different measures facilitate change within the French context through a brief review of both recently adopted measures stemming from the ETGG Law as well as the existing legislation.

This section analyses some of the most relevant decisions taken in the past and the philosophy that guided them. The analysis does not aim to be comprehensive, but rather to illustrate an increasingly marked shift towards a more sustainability-friendly financial system. The focus on climate- and energy-related issues is due not only to the importance of the COP21 political dynamics at the time of writing, but is also a direct consequence of Article 173 of the 2015 ETGG Law.[18] As detailed below, this legislation mandates the development of a national low-carbon strategy, national carbon budgets and dedicated measures targeting different actors. Nevertheless, the integration of sustainability into the financial sector in France addresses a broader spectrum of subjects (see Section 2) than recent legislation and sector-wide dynamics. Therefore Article 173 should be seen as the latest episode of a process spanning over fifteen years.

3.1 Transparency and reporting: targeting both financed companies and financial institutions to improve risk assessment

The integration of sustainability issues into the financial sector requires reliable information concerning financed companies, assets and securities. As with other topics, improving and sharing information is the first necessary step for behavioural change. Moreover, disclosure policies are often seen acceptable to many stakeholders and therefore relatively easier to implement. This appears to be why initial regulatory steps in France to integrate sustainability issues into the financial sector have focused on broadening and improving disclosure.

In practice, the benefits of a transparent reporting on sustainability issues differ depending on the type of actor. Indeed, the issues at stake – and the rationale behind reporting – differ between financial institution, 'financed' firms or non-financial corporations. In many instances however, the financial sector is constrained by the quality of reporting at the company level – whether financial or non-financial – to guide its decisions. The 2010 Grenelle II legislation introduced the first distinction between financial and non-financial institutions through Article 224 targeting asset managers (see below). This separate treatment through differentiated reporting requirements for financial and non-financial corporations has continued with the 2015 ETGG Law and additional reporting requirements for financial institutions compared to financed companies.

3.1.1 Financed companies: providing the foundation for low-carbon investment strategies

For corporate actors, part of the 2001 New Economic Regulation law (NRE) dealing with Corporate Social Responsibility (CSR) reporting for listed companies focused mainly on governance and social issues. The 2010 Grenelle II law expanded reporting requirements to environmental issues, including the tracking and reporting of corporate GHG emissions. It also widened the scope of companies covered by these requirements, including all companies with more than 500 employees or with an annual income or assets worth more than €100 million.

In terms of mandatory GHG reporting, this included direct and some indirect GHG emissions required through two different provisions: i) Article 75 including a dedicated GHG monitoring and reporting process, and ii) Article 225 broadening existing CSR reporting to include 'corporate, social and environmental responsibility' issues. As a result, the Grenelle II law unfortunately established two separate mandatory reporting requirements for GHG emissions with different requirements on the scope, the precision, the periodicity and the verification.[19] This lack of harmonization was criticized as a source of unnecessary costs. Furthermore, the implementation of the EU Energy Efficiency Directive has added energy audits

[18] Formerly known as the article 48bis.

[19] See Morel and Cochran, 2015 for a discussion of the up to four different mandatory or voluntary emissions monitoring and reporting frameworks to which French companies might be subject to.

as a requirement for many of these companies. While often perceived as burdensome, it is expected that multiple frameworks – if there is a minimum level of coherence – are not necessarily unmanageable in the longer term as a learning curve can be observed within the organization that can decrease the marginal cost of such reporting (Morel and Cochran, 2015). Furthermore, it should be noted that while the reporting and the disclosure are mandatory, no sanctions are planned, for now, for companies that do not comply.

In light of the second wave of reporting under Article 75 that will be due in 2016 and in an effort to resolve some of these difficulties, the 2015 ETGG legislation has taken steps to correct this double reporting requirement and align the multiple GHG reporting requirements by allowing the government to unilaterally modify reporting requirements, including the scope and the periodicity.

Additionally, the 2015 ETGG Law implemented two major new items on climate-related reporting. First, it requires both financial and non-financial companies to include their exposure to financial climate-related risks and their low-carbon strategy in their reports and communication with shareholders (Article L. 225-37 of the Commercial Code). Second, companies must disclose the impacts of their activities and products on climate change (Article L.225-102-1 of the Commercial Code). The secondary legislation laying out the technical details on what must be disclosed has yet to be published. However implementation will have to take into account the complexity associated to the concept of the lifecycle of goods and services. As such, decisions are expected on whether a mandatory reporting perimeter is set for scope 3 GHG emissions – or at least a requirement to be transparent on the choices made – given that a fully standardized scope 3 emissions does not seem appropriate for all sectors. A coordination with the process of implementation of the EU directive on disclosure of non-financial and diversity information is also expected.

The rationale behind these two new legal requirements demonstrates a strategy also seen in Section 3.3 on steps to improve risk assessment. Two objectives can be noted:

- First, reporting will push companies to take the initial steps necessary to reduce any informational barriers to action through the identification and consideration of the climate-related risks they face as well as their role in supporting or hindering the low-carbon transition.
- Second, it tends to ensure the provision of additional information to investors to help them adequately price climate-related risks. As such, investors will begin to have access to the information necessary to implement risk management strategies that are more accurate – whether based on portfolio reallocation, shareholder engagement or other approaches. Indeed, the lack of relevant and sufficiently detailed data is often presented as one of the main barriers to better assessing climate-related risks and implementing low-carbon investment strategies. In this perspective, the relevance of the provided information will most likely depend on how scope 3 emissions are reported (2°ii, UNEP FI and WRI, 2015).

3.1.2 Financial institutions: adequate risk pricing as a minimum requirement

The introduction of mainstream ESG reporting for financial institutions started in 2010 through the adoption of the Grenelle II law addressing a broad range of environmental issues. Article 224 of this law requires asset managers to report annually on how they include Environmental, Social and Governance (ESG) criteria in their investment strategy and the management of their funds. These requirements were subsequently outlined in the Monetary and Financial Code (Article L533-22-1), the Commercial Code (Article L225-102-1) and in the corresponding secondary legislation (n° 2012-132).

In 2014 the Plateforme RSE – an official group of stakeholders dedicated to the implementation of CSR strategies (Plateforme RSE, 2014) – conducted a review of these reporting requirements. Their assessment identified a high level of reporting among asset managers that was heterogeneous, which

was interpreted as indicating that the reporting requirements for asset managers had prompted only limited appropriation of these issues by asset holders such as institutional investors.

Article 173 of the 2015 ETGG Law has extended this reporting requirement to institutional investors. In addition to reporting on the inclusion of ESG criteria in their investment strategies – with the climate-related dimension made more explicit – they are also required to assess how their investment strategies are consistent with and contribute to the low-carbon transition.

The French administration is expected to issue the secondary legislation within six months following the publication of the law. The decree will provide guidance regarding how institutional investors are expected to report on their exposure to climate-related risks, how their investment strategy takes these exposures into account, as well as how these strategies are aligned with or support national and international objectives on climate change. It is nevertheless expected that covered financial institutions will be required to report on the methodologies and tools used to assess the exposure of their various portfolios to climate-related risks with a clear description of the methods and a justification of the choices made. In addition, institutional investors are required to report on how their votes in shareholders assemblies take into account their low-carbon strategies. In this perspective, there appears to be a push to create space for shareholder engagement to be successful.

This risk-based approach appears to be seen by the State and other proponents as a critical part of the appropriation of climate-related challenges by mainstream financial institutions. Significant space is expected to be left to institutions to develop the indicators and tools most relevant to their specificities. Indeed, the key objective of the law is to nudge the sector toward a better assessment of climate-related risks (taking into account differences between asset classes or portfolios), foster the development of the necessary tools, and identify emerging best practices.

Therefore, there is no imposed individual strategy but rather a push for financial institutions to put climate-related issues on the radar and to adequately price climate-related risks. As such, the French State is promoting the appropriation of these issues mainly through a supervision-oriented approach rather than additional regulation.

This rationale is in many ways similar to the strategy developed by other institutions internationally. For example the Bank of England asked insurance companies to disclose their exposure to climate-related risks. At the individual institution level, the Norwegian Sovereign Fund implemented a risk-oriented review of its portfolio (Norges Bank IM, 2015). The expected impact is similar as the minimum requirements in France: any portfolio reallocation induced by this review would be the consequence of a pre-existing mispricing of the risk. It must be noted that the same exercise applied to all French institutional investors may have different outputs than the Norwegian Fund as the time horizons and portfolios differ.

Challenges nevertheless remain. For example, regarding the internal low-carbon strategies and alignment with national and international objectives, the law requires institutional investors to "comply or explain". Disaggregating national and international objectives so that investors could assess the consistency of their investment decisions with and their contributions to these objectives poses a number of technical difficulties. However, one of the roles of the national low-carbon strategy mandated by Article 173 will be to create a reference framework within which financial institutions will be able to compare their actions.

Finally, if attention has most recently focused on climate-related issues, French reporting requirements address broader ESG issues and recent developments on climate change result from a twenty-year dynamics on ESG. Legislations on reporting must be seen as a way to implement minimum requirements on all companies and to structure the disclosure process.

3.2 Addressing capital mobilization issues through a mix of public and private initiatives

As seen in the previous section, an improving risk assessment is often seen by authorities as the main trigger to shift capital allocated by mainstream institutions in a way that is consistent with the transition towards a resilient and low-carbon economy. Nevertheless, while improving information is a first and necessary step, it is not necessarily sufficient to address all challenges regarding sustainable development. Scaling up climate or sustainable finance may also require more direct intervention and approaches. Since 2008, financial markets are characterized by high volumes of available liquidity and, to some extent, a search for yield that has led to a race for longer maturities and increased risk taking. One hypothesis is that this context would have led to increased levels of finance flowing to low-carbon projects if the barriers to investment were only on the side of the financial sector, and more specifically capital providers.

However, this has not been the case. For some experts, there is clear evidence that the 'pipeline' of climate projects is not deep and robust enough.[20] As a result, in many instances priority has been given to the implementation of sustainable, coherent and ambitious 'demand-side' policies. This approach seeks to implement robust climate policies ensuring the emergence of a carbon price and to develop a consistent and clear national strategy for the transition that could then entail a regular pipeline of robust green investment projects. Improving the risk/return profile of climate-related projects relative to carbon-intensive investments is thus a prerequisite to make them bankable or financially attractive to private actors.

While essential, this report does not address these policies in detail are as they often go well beyond the scope of the financial sector.[21] This section will rather focus on the public and private initiatives that have been implemented in France to foster green capital mobilization through addressing market failures in the supply of capital. In France, these have mainly taken three forms: public financial institutions to address market failures and foster market development; market structuration through the use of labels; and implication of French actors in the development of green bonds.

3.2.1 Mobilizing public financial institutions: CDC and Bpifrance

While public financial institutions represent a relatively small part in the volume of the French financial system, they implement targeted interventions to support national policy objectives through direct financing, market development and capacity building.[22] While the present analysis will focus on French institutions, other European actors play a role at the French level. For instance, the European Investment Bank has provided hundreds of millions of euros for climate projects in France in 2011 (I4CE, 2014). Moreover, the EIB, through its unique positioning at European level has spread knowledge and practice to other actors in Europe and worldwide (Cochran *et al.*, 2014).

3.2.1.1 Caisse des Dépôts et Consignations: giving impetus to new practices

The *Caisse des Dépôts et Consignations*[23] is a French public financial institution created in 1816. The CDC and its subsidiaries making up the CDC Group are involved in a broad range of social and economic sectors and is equally an important financial and asset manager – entrusted with multiple programs funded

[20] To have a more comprehensive overview of this question see (Financing the Future, 2014). The definitive answer may be a mix of these issues as signal perception is crucial in climate finance mobilization and is the responsibility of all actors. For example, the Canfin-Grandjean commission (2015) that worked on mobilizing public and private climate finance addresses both issues related with the financial sector or not.

[21] See (OECD, 2015) for a discussion of Aligning Policies to Support the Transition.

[22] See Cochran *et al.* (2014) for a description of the role of PFIs in Europe in supporting climate action.

[23] Disclaimer: CDC is one of the main sponsors of I4CE. I4CE has a total independence on the content of its writings.

by the French government and with the investment of mandatory deposits from the legal profession (see Section 1). Applying the logic of an '*investisseur avisé*'[24] with thus a focus on maximizing returns on investment, it can play a role in the French economy that other actors are less apt to fulfil – particularly in terms of volume and relatively long-term tenure of loans – as well as targeted equity investments.

The CDC's own balance sheet is €150 billion with roughly a fifth used for equity investments. The *Fonds d'Épargne* provides debt financing for eligible entities using the €250 billion of regulated savings it has been mandated for management.

The CDC Group has operational links with a number of pension funds. This implies regular knowledge sharing between these institutions, including FRR and ERAFP – both early members of the Portfolio Decarbonization Coalition – and Ircantec – signatory of the Global Statement on Climate Change and Montréal pledges.

CDC Group is a recognized actor within the French financial community. For example, CDC actively advocated for the creation of the UN Principles for Responsible Investment (PRI) that have been adopted by more than 100 institutions in France. The CDC has its own SRI policy implementing specific investment strategies depending on asset classes that also makes a specific point on shareholder dialogue with invested companies.

In 2015, CDC announced its dedicated strategy on climate change issues and the broader ecological and energy transition, comprising four main commitments regarding capital mobilization but also other means of intervention (CDC, 2015):

- Financing Energy and Ecological Transition (EET): €15 billion for all the CDC group (including Bpifrance) between 2014 and 2017
- Decarbonizing both infrastructure and building portfolios
- Shareholder engagement and activism for the EET
- Monitoring and reporting of GHG financed emissions and in-depth sectorial analysis to identify potential loopholes (e.g.: coal)

3.2.1.2 BPIFRANCE: INNOVATION, GUARANTEE AND LOANS

Bpifrance is a joint subsidiary of the French State and of the CDC. It was created in 2013 with the aim to consolidate the existing public institutions and funds involved in the debt and equity financing of French companies in order to coordinate and amplify their impact. It contributes to the financing of a large range of businesses – from start-ups to larger listed firms – through various instruments including loans, guarantees and equity. It has a clear focus on addressing market failure in innovation and growth or investment financing. Historically, the institutions that have been combined in Bpifrance have been involved in financing private innovation in France. This includes the management of €3 billion of the *Investissements d'avenir*.[25]

Bpifrance is required to produce an annual report on its actions and the resulting impacts. More precisely, it must detail how supported businesses "contribute to the ecological and energy transition" (Law creating Bpifrance, 2012). Until now, this reporting has focused on the funding dedicated to companies in relevant sectors or specific operations. Bpifrance reports that it provided more than €800 million in 2014 for these uses (Bpifrance, 2015). In its strategy regarding the energy and ecological transitions,

[24] A combination of social and financial objectives and criteria allows *Caisse des Dépôts* to act as a "sensible investor" (*investisseur avisé*): while focusing on the public interest, CDC respects market forces and aims not to favour any actor over another when acting on the basis of an explicit public mandate.

[25] *Investissements d'avenir* is a State program initiated in 2010 to finance public and private research and innovation projects.

Bpifrance emphasizes the priority of reducing the energy consumption of businesses. It is therefore expected that support of this theme will be expanded in the coming years. Regarding the broader issue of sustainability, Bpifrance implemented a social responsibility charter and a socially responsible investment strategy; an ESG due diligence is required as part of the assessment of each investment (Bpifrance, 2013).

However, Bpifrance's approach currently focuses only on positive impacts of its capital mobilization for the energy transition. An assessment of the coherence of its whole portfolio with the energy transition objectives would represent a further, useful step as is the case for other financial institutions.

Through its public financial institutions, the French State covers many sectors, activities and issues related to sustainable development. These institutions address identified market failure and intervene through targeted instruments aiming at leveraging private actors or through pilot programmes. Nevertheless, the volume of flows explicitly supporting sustainable investment practice remains modest compared to the overall annual activity. Therefore there appears to be an opportunity to improve and maximize their contribution to, and overall consistency, with the objectives of the energy transition and sustainable development.

3.2.2 The labelling of financial products

Mobilizing capital for sustainable projects often depends on the ability of capital holders – whether household or financial institutions – to have sufficient information to make informed choices. In addition to transparency and reporting, the labelling of financial products in France is seen as a useful tool to support the development of Socially Responsible Investment products. The purpose is to give sufficient, reliable and concise information on extra-financial issues to inform investors' choices.

The labelling initially developed through private initiatives. For example, Novethic implemented a rating system for SRI funds in the mid-2000s. The rating was seen as ambitious, aiming to differentiate different SRI funds depending on their level of ambition. Given the technical complexity of the resulting information rating, it has however been used almost exclusively by professional investors. In 2009, Novethic developed its own SRI label aiming to assist households and asset managers to distinguish between the increasingly large number of self-labelled SRI products. This label has evolved to evaluate the quality of the SRI products. It has resulted in incentivizing asset managers to improve the quality and transparency of their reporting on SRI-related issues.

In 2012, the French government announced its intention to create a publicly-sponsored SRI label. Following two years of discussion, the decision was made after the 2014 Conference on the financing of the energy transition (see Section 3.4) to create an Energy Transition and Climate label and a more generic SRI label, which were presented in October 2015. The underlying rationale behind creating public labels is to ensure a common ground. The implementation of the labels, however, may be complex as decisions regarding the criteria and rating methodologies are ultimately public decisions while certified entities will be responsible for attributing scores to individual products. Furthermore, as they are often applied to 'niche' financial products and mainly visible to actors in the sustainable finance area, these labels are not expected to be the silver-bullet solutions regarding the financing of low-carbon transition.

The finalization of the two labels was still underway at the time of publication. A public consultation was launched in October on the rules guiding the Energy Transition and Climate Label. The SRI label is expected to enter into force in 2016. From the information available, it appears that both labels will require the measurement of the impacts of funds on energy and SRI issues and link them to explicit objectives.

3.2.3 The French contribution to the development of green bonds

The developing green bond market has experienced fast growth in the past two years. With US$32 billion of issuance as of 30 October 2015, some observers think that issuance at the end of 2015 will reach or exceed the 2014 record of US$37 billion.

French actors have played a significant role in the development of the green bond market. French market players were overrepresented compared to other countries in the past years at almost every stage of the green bonds chain: issuers, underwriters and second-opinion providers (Europlace, 2015).

This high level of participation is particularly visible on the issuer side and among underwriters, and less so on the buy side where a number of French market actors are active and have developed an expertise (e.g. Mirova), although not beyond levels seen in other countries.

On the issuer side, a broad variety of French market actors were responsible for some of the biggest or most significant issuances. Indeed, as early as 2012, the Region Ile-de-France issued one of the first large sub-sovereign public green bond for an amount of €350 million, renewed with a record-breaking issuance of €600 million in 2014. On the private sector side, the largest issuance came from French companies: EDF issued a €1.4 billion green bond in 2013 and Engie issued the biggest green bond to date at €2.5 billion in 2014. The *Agence Française de Développement* (AFD)[26] joined other development banks with a €1 billion climate bond of its own in 2014. At the end of March 2015, France was the leading country in terms of total outstanding green bonds issued (Europlace, 2015). Over the last few years, the diversity of actors and countries involved in the market increased as the market expanded. The relative weight of French actors in the broader green bond market will probably decrease without necessarily being the result of any disengagement.

This over-representation of French actors appears to have been catalysed by the existence of a favourable ecosystem of expertise. Several French underwriters including Crédit Agricole CIB, Société Générale CIB and Natixis played a significant and – for some of them – early role in the development of the green bond market. This close access to experts helped issuers seize the opportunity and develop the capacity to issue green bonds. In addition, the presence of ESG-rating agencies such as Vigeo – the second most used third party reviewer for green bonds – helped some of these institutions develop their green bonds. This ecosystem of actors has contributed to the role of French actors in this new market segment (see Section 3.4 on financial culture for a further discussion).

3.3 Risk and prudential frameworks: towards a better assessment of risks

The push for an effective integration of climate and sustainable development issues into the risk assessment and management framework is, as in the rest of the world, a recent development. While ESG integration started to develop risk-related approaches regarding ESG criteria, the relatively low level of implementation meant that impact remained marginal.

Through Article 173, the ETGG Law included an innovative set of measures that require financial sector actors to report on how they take climate-related issues into account in their investment and risk management strategies. The law does not seek, however, to impose specific tools or internal policies to improve risk assessment and management. Rather, the underlying rationale is, through a reporting obligation, to ensure that actors are aware of the risks and take steps to price and manage them adequately.

Indeed, risk perception and management is increasingly viewed as necessary for all financial institutions. An improved inclusion of climate-related issues in risk perception appears essential for the financial system

[26] Disclaimer: AFD is one of the main sponsors of I4CE. I4CE has a total independence on the content of its writings.

to integrate climate-related issues in capital allocation and financial decisions, thus fully playing its role as the efficient capital allocator in the economy. Given the ETGG's objective to incentivize innovation and enhancement of practices and tools, the law should be interpreted as setting the minimum requirements for all institutions. As such, ambition is not capped but issues to address are set as a minimum threshold.

The law makes a distinction and tailors requirements between banks on the one hand, and asset managers and institutional investors on the other hand. These different provisions are described in the following sections.

3.3.1 Banking sector: the role of stress tests and the focus on time horizons

Risk management is inherent to the banking sector. As seen in the first section, it is both a matter of stability and performance as it is directly linked with prudential policies and leverage ratios. As demonstrated since 2008, the banking sector can adjust its business model more rapidly than other financial actors.

In France, increasing attention has been placed on the banking sector and its involvement in the financing of carbon-intensive assets – such as the multiple NGO campaigns targeting the financing of the coal industry. If these campaigns may not be interpreted as direct financial risks, they are in general perceived as reputational risks by banking institutions.

Legislation in France addresses climate-related risk management using approaches found in the existing 'mainstream' supervisory toolkit. The ETGG Law has included measures targeting French banks into the Monetary and Financial Code (article L. 511-41-1 B), focusing on what is seen as the key tool to assess vulnerabilities for banks: stress tests.

The ETGG Law clarifies, into the Monetary and Financial Code, the requirement for banks to integrate in their procedures the follow-up of the results of regular stress tests. These stress tests are included in the same article requiring banks to have risk assessment and risk management strategies focusing on standard bank risks such as credit risk, counterparty risk, market risk, securitization-related risk, interest rates risk, liquidity risk, etc.

Simultaneously, the banking supervisor is expected to develop stress test methodologies that will integrate climate-related issues. In their most ambitious form, such stress tests would allow banks and their supervisor to assess the exposure of individual banks to climate or carbon risks. If these risks appear to be material, it is expected that they will be recognized and managed, leading to a capital reallocation that will, at a minimum, reduce an institution's exposure, and ideally lead to a level consistent with expected climate developments.

The technical means to administer this form of stress test so that it operationally integrates climate-related issues is still under development. A key issue is a shift in time horizon: while current stress tests for banks rely on short- to medium-term time horizons – or approximately 1 to 3 years – climate-related stress tests will need to focus on the long term: carbon risks and physical risks – such as changes in the sea level or natural resources availability – are likely only to partly emerge at levels to be considered material beyond a 3-year time frame. This raises a second key issue of stress tests of whether to hold constant the bank's current strategy during the test, or allow for modification. Such a choice will have an impact on how these instruments can be structured to produce results with clear operational implications (2°ii in partnership with UNEP Inquiry and I4CE, 2015).

The French government is expected to release a report outlining expectations in terms of the implementation of climate-related stress tests for banks by the end of 2016. No information is currently available concerning the level of detail of requirements and guidelines that will be issued.

3.3.2 Climate-related risk reporting for institutional investors: establishing a coherent package

Until now, risks related with extra-financial issues for institutional investors were mainly tackled in France through SRI and ESG integration. SRI has been gaining traction among these institutions in France for twenty years.

The ETGG Law extended the scope of reporting and impacted institutions, and included the assessment of climate-related risks. Climate-related risk disclosure has become a minimum requirement applying to investments in financial and non-financial institutions. Article 173 of the ETGG Law requires the development of a National Low-Carbon Strategy (NLCS). By giving a clear vision of the expected regulatory framework, the NLCS provides information to better assess carbon risk. As such, Article 173 can be interpreted as a coherent package setting up minimum requirements for risk assessment and improving available information to facilitate this assessment.

These expanded reporting requirements appear, however, to apply only to institutional investors and not asset managers. It is nevertheless expected that asset managers' mandates will evolve in a similar direction in response to demands from institutional investors for improved knowledge on the impacts of their portfolios. Therefore, a combination of expanded reporting requirements and changes in mandates given by institutional investors is expected to facilitate an evolution in the asset manager practice.

This process in France is in many ways independent of the dominant view of fiduciary duty. Indeed, it should be noted that the concept of fiduciary duty in the Anglo-Saxon world – where it is seen as a means to push asset managers or pension funds to improve the management and reporting of climate-related risks – is not framed in the same way in France (see Box 2). In France, when the management of assets is delegated, an asset manager's duties and requirements are typically directly laid out in formal mandates or regulation. As such, besides possible direct evolutions on asset managers' mandates, more active engagement from asset owners with their asset managers can be expected.[27] Therefore, a slow and gradual inclusion of climate-related issues in mandates should most likely be expected.

Box 2: Fiduciary duty in France

While conceptually appealing and generally identified as an opportunity to ensure that asset managers are taking climate-related developments into account, in practice, the concept of fiduciary duty has a different bearing in different legal systems. Indeed, fiduciary duty is a notion that originates in common-law system (uncodified) in the Anglo-Saxon world. Transposition in civil-law system (codified) in continental Europe is more limited.

Fiduciary duty in the Anglo-Saxon world often references the role of the trustee and the notion of a trust. The trustee has the fiduciary duty to act in the best interest of the client and to provide them with the best information possible. In that sense, it has been seen as an opportunity to develop climate-related risks assessment by incentivizing trustees to report on those risks in order to avoid legal risks regarding the trust (Ceres, 2014, Global Compact *et al.* (2015), DG Environment, forthcoming). Indeed, some analysts contend that traditional fiduciary duty includes climate-related risks. Failing to take them into consideration should therefore be perceived as a litigation risk for trustees as they would not be taking all necessary actions to fulfil their mission.

In France, French pension funds are built on the insurance model and do not act as trustees. As such, obligations equivalent to 'fiduciary duty' do exist in France – but are set out in statutory provisions regulating the conduct of investment decision makers or existing guidelines. The systemic way to include climate-related issues in France is consequently not related to litigation risk, but rather to a change in broader regulation – whether targeting institutional investors or asset managers.

3.4 Building capacity: a unique ecosystem of actors aware of sustainability- and climate-related issues

Building capacity on sustainability issues in the financial system may be one of the less discussed stakes. Indeed, it is a large and complex topic that mixes several scientific domains and has to be managed at the micro 'investor' level rather than being addressed only at the level of macro market-wide dynamics.

3.4.1 French capacity building: the Grenelle model

Spreading awareness on sustainability and climate-related issues is key both to foster changes in behaviour as well as to facilitate the implementation of needed policies. In France, policies such as the ones described in this report have been made possible due to the existence of an ecosystem of actors able to raise attention on issues, to bring expertise, and design and implement regulations. Some of these policies would not have occurred without the advocacy of individual actors engaging with the State and lawmakers. Furthermore, the implementation of these decisions would not have been possible without the internal or external expertise of the impacted institutions.

This ecosystem is mutually reinforcing rather than fixed or unidirectional. On the one hand, the development of expertise among institutions has been facilitated by signals from the public sector and reinforced through regulation. On the other hand, the receptiveness of the State to the advocacy or expertise has helped strengthen the dynamics that have developed within the ecosystem. At times legislation has pushed actors to progress faster; on other occasions regulation has been advanced by the experience and expectations brought by the actors in the field.

The French approach to mobilize consultation on environmental-related laws, the 'Grenelle' consultation model, aims to bring together the broader French financial ecosystem – financial institutions, NGOs, think tanks, State agencies, etc. – to collaborate and discuss on these topics. In this approach, debates are organized in 'colleges' representing different actor groups: the State, employers, employees, local governments, NGOs, and most recently elected representative and consumers. This process enables the identification and inclusion of the range of relevant organizations working on these questions. In some instances, it has launched internal discussions of environmental issues within participating institutions. This kind of process appears to be a successful model to create a momentum among actors and accelerate the pace of exposure to – and uptake of – key issues.

3.4.2 Understanding how the climate-related French dynamics have progressed to include the financial sector

However, to date actors from the financial sector have in general remained external to Grenelle-style discussions. During both the Grenelle and the National Debate on Energy Transition a dedicated college was not created to explicitly engage actors from the financial sector. Nevertheless, the engagement of the financial sector on sustainability and climate-related issues is gaining traction.

For example, the specific challenges of financial sector led to the preparation (2012-2013) of a joint report by the CGDD and the DG Trésor of the financing of the transition (DG Trésor and CGDD, 2013). One of the few reports of its kind focusing specifically on the role of this sector on environmental issues in France, it explored options for mobilizing private financing for the ecological transition co-written by both the Finance ministry and the Environment ministry (DG Trésor and CGDD, 2013). The report made recommendations concerning four main principles: improve economic signals – including their predictability; implement complementary financial tools to target energy transition finance: strengthen

[27] Recently, ERAFP, Cedrus AM and amLeague launched a SRI competition for asset managers in portfolio decarbonization.

the integration of ESG criteria for all sectors, including the financial sector; and improve awareness and expertise on the stakes and the objectives of the transition. Several recommendations have ended up in the final ETGG Law. Following its publication, the State organized a dedicated *Banking and Financial Conference* in mid-2014 designed to catalyse discussions for the financial aspects of ETGG law.

More recently, the hosting of and run-up to the 21st meeting of the UNFCCC Conference of Parties – COP21 in December 2015 – have played a major role in accelerating the discussion and action within the financial sector in France. This has led to proposals emerging on innovative mechanisms such as the implementation of a social value of carbon for the financing of climate-related projects (Aglietta *et al.*, 2015). The report of the Canfin-Grandjean Commission on Innovative Climate Finance (2015) – mandated by President Hollande – is another illustration of the increasing attention given to engaging the financial system on sustainability and the interaction between politics, civil society and the financial sector.

Furthermore, it appears that the run-up to COP21 has created opportunities and additional support for some of the recent regulatory changes such as Article 173 in France. The article was adopted over the second reading which occurred during the Climate Week in Paris in May 2015. The government demonstrated support for the inclusion of the amendment and the French Finance Minister announced its adoption as a milestone in line with COP21 during Climate Finance Day of the Climate Week. In collaboration with others, French authorities also played a significant role in ensuring that these issues gained policy attention within international discussion (G20 mandate to the Financial Stability Board, European Union discussions).

Finally, over the past years major French financial institutions have taken concrete positions and commitments on climate-related issues. This enhanced appropriation has helped improve the legitimacy of individuals working on these issues within these institutions and ensure that climate and other sustainable development issues are on the agenda. This reflects in general an increasing appropriation of climate-related issues by the top management of different financial institutions and builds on the longer trends described above linked to the emergence of a sustainability-aware financial ecosystem and regulatory frameworks. For example, French banks released sectorial guidelines for the energy sector in the beginning of 2013, well before COP21 became an argument.

4 A BALANCE TO BE MANAGED CAREFULLY: OVERCOMING IMPLEMENTATION CHALLENGES

As discussed in the previous sections, France has adopted a set of measures mandating reporting on ESG and climate-related issues following a general 'comply or explain' approach. This strategy faces three challenges: i) overcoming technical challenges to adequate application in practice; ii) ensuring internal and broader usefulness of the resulting information for financial actors; and iii) its ability to spark a larger dynamic with expanded impact – both in France and abroad. These challenges are in and of themselves closely linked, but also depend on the capacity of the broader ecosystem to facilitate implementation and uptake in a manner that creates added value for the financial sector actors. Indeed, as described in Section 2, the ecosystem of actors relies on a careful balance between financial and sustainability concerns that may be tested by both the post-COP21 period and the technical implementation of the new regulatory requirements.

4.1 ENSURING THAT FINANCIAL INSTITUTIONS HAVE THE MEANS TO APPLY THE LAW

Institutional investors have to report on the contribution of their portfolio in relation to both international and national objectives. Being able to translate these objectives in operational indicators remains a challenge. Overcoming the technical challenges to adequately apply the reporting requirements found in the ETGG Law implies finding ways to define indicative climate financing targets for institutions. To be feasible in practice, this must most likely be supported by available tools and based in part on available data. Furthermore, to be operationally useful, such indicators may need to be more detailed than what is expected to be included in both secondary legislation and the national low-carbon strategy.

Similarly, the availability of methodologies and informational tools to help institutions comply with the regulation is essential. Further developments in the near future are expected around the implementation of these new requirements and the ramp-up of actors' capacities to comply with them. In this perspective, the role of the entire ecosystem – particularly commercial and non-profit expertise – will be essential. Data providers, methodology developers and knowledge-sharing fora will be key to support these developments.

4.2 ENSURING MATERIALITY FOR FINANCIAL ACTORS: RELYING ON BOTH HARD AND SOFT LAW

Compliance of financial actors with a regulatory framework based on a supervision-oriented approach rather than on additional regulation requires that the information produced is useful and the risks are seen as material. Indeed, approaching climate actors through risk, whether financial or reputational, is a

way to make the financial system fully play its fundamental role and thus complementing climate policies. However, while the current reporting framework is technically 'hard law', there are no legal sanctions for non-compliance. This, in and of itself, is not necessarily problematic. Indeed, in some cases when the hard law is too constraining, compliance may be concentrated in the legal department rather than in the more appropriate operational teams. As a result, a mix of 'hard' – or legally binding with sanctions – and 'soft' laws – or those that are quasi-binding – can be expected to spur compliance. Moreover, developing financial culture among actors will definitely be essential to increase the appropriation of issues and thus the ability of institutions to implement the law.

In both instances, however, a combination of hard and soft law will only work if assessed risks become material. Materiality can be based on both the assessment of factors influencing risks as well as reputational issues.

First, the appropriate pricing of the associated risks implies ensuring the emergence of a broader economic context where regulatory frameworks explicitly or implicitly price carbon-related externalities. Efficient climate policies critically hinge on a financial sector that adequately plays its role and allocates capital to projects at an appropriate risk premium. As such, it is important to see the role of the financial sector as a piece of a larger climate policy puzzle: supply-side policies aiming to foster the integration of climate-change into the activities of the financial sector must be seen as complementary to demand-side policies and regulations that create an economy where low-carbon investment opportunities arise and generate competitive – if not superior– financial returns (Morel *et al.*, 2015).

Second, reputational risks can also increase the materiality of climate- and sustainability-related topics. When reputational issues are at stake, feedback from within the broader ecosystem will probably push actors to comply. Partner companies, investors or non-profit institutions will each play a role in pushing actors to comply or explain why they have failed to report and comply sufficiently with requirements. Some follow-up on the implementation of decisions will be crucial to enhance their impact, whether done by the supervisory institutions,[28] professional associations or non-profit organizations.

However, the dynamics within the ecosystem are complex and fragile. Financial institutions are currently controversy-averse on climate-related topics – the result of commercial reasons and headline risks due to the attention drawn to these subjects in the run-up to COP21. However, this cannot be taken for granted: if financial sector actors are subject to regulation that they are unable to meet or subject to repeated controversies or public criticism on these issues despite progress made, this could discourage further action. Similarly, if the commercial reasons and impetus from broader economic actors to address climate-related issues do not become material – i.e. if demand-side climate policies proved to be deficient – motivation to keep prioritizing action in this area may drop. Thus, the broader climate- and sustainability-dynamic within the broader ecosystem needs to remain strong.

As described above, the existing supervision-based regulatory framework has the objective to provide minimum requirements to all institutions. In this perspective, it is not necessarily designed to tackle all low-carbon transition challenges, but rather to ensure that all institutions are aware of them and have the opportunity to take preventive action. Some financial actors in France insist that the risk approach is not perceived as sufficiently material given the continued uncertainty around demand-side climate policies, thus preferring to go further and implement climate-performance strategies – 2°C alignment for instance. Nevertheless, the existing regulatory framework does not prevent actors from doing so if they want to. Moreover, such early adopters are key in supporting the development of instruments and reliable information that all institutions will be able to benefit from.

[28] They are the *Autorité des Marchés Financiers* (AMF) for asset managers and the *Autorité de Contrôle Prudentiel et de Résolution* (ACPR) for institutional investors and banks.

4.3 Sharing experience: building on the French experiment at the European level

The last – but not least – challenge that the French framework will have to face is situating evolving domestic practice within a clearly international financial system. Maintaining a level playing field with international peers while simultaneously encouraging institutions to seize new business opportunities and stay at the forefront of innovation in the area is a difficult exercise. Indeed, some French institutions cited potential impacts to competitiveness stemming from increased reporting costs. As such, discussions have turned to the value and pathways of expanding certain reporting frameworks – including Article 173 of the EETG Law – to other countries at the European level. The ongoing discussions at the EU level around the "Capital Markets Union" have been specifically identified by several financial institutions as potentially the most rapid and relevant way to implement at the EU level regulation that improves the integration of sustainability issues into the financial sector (2°ii and UNEP Inquiry, *forthcoming*). Similarly, the work on stress testing for banks could be connected with the work of the European Systemic Risk Board.

Particularly on topics such as climate change strategies, the '*exception française*' at times encounters difficulties to find a place within existing international initiatives for approaches that may be difficult to replicate in foreign contexts. This has been a recurrent theme – and sometimes a stumbling block – in terms of sharing practice and expertise internationally in an effective way. There are reasons to think this time is different given that there is not a single 'French methodology' to address these issues and there is a visible tendency to align with practice developing internationally.

There rather appears to be a larger 'French philosophy' emerging to address these issues. Indeed, the new framework gives significant leeway to individual institutions to find their own way forward. Moreover, by hosting COP21, France is in a strong position to showcase progress made on both climate – and broader sustainability – issues internationally. For example, it played a key role in pushing the G20 Finance ministers to request the Financial Stability Board to review how climate-related issues can be taken into account in the financial sector (G20, 2015). The combination of the domestic dynamic and the 'COP21 springboard' present an opportunity to share recent regulatory evolutions and this broader French philosophy of addressing the sustainability issue. Therefore, discussions at the European level may be the next step after the implementation of the framework in France.

CONCLUSION

Over the past twenty years, France has implemented an ambitious framework of action tackling a number of the areas identified as key by the UNEP Inquiry. The public, commercial and non-profit actors of the French financial ecosystem have together facilitated the emergence of CSR and ESG reporting practice and requirements. This has been most recently enriched with a specific focus on the climate-related issues and low-carbon transition. The resulting supervision-oriented approach has led to the emergence of risk assessment, capital mobilization and the rise of a financial culture increasingly attuned to sustainability issues:

- On **transparency**, France has implemented an innovative framework based on existing progress in reporting extra-financial reporting to push both financed companies and financial institutions to improve risk assessment. Most recently, evolutions have focused on climate change-related physical and policy **risks** leading to the development of a national low-carbon strategy, national carbon budgets and a climate-related risk disclosure requirement tailored to different actors such as banks and institutional investors.
- On the **capital mobilization**, France combines public and private initiatives to address market failures. Public financial institutions are used to drive capital and provide capital where private actors are not in a position to do so on their own. The implementation of labels, and the mobilization of French actors in the development of green bonds also show the will to structure markets.
- On **financial culture**, the expertise of the financial sector on sustainability issues has grown over time. This has led to the development of an 'ecosystem' of financial and non-financial actors, each actively playing a role to further the integration of sustainability (and in the run up to COP21, climate-related) – issues.

Some of the steps taken are relatively new, which makes it difficult to assess what the ultimate medium- and long-term impacts will be. Nevertheless, a number of pieces of the framework are noteworthy as well as the broader rationales structuring this 'ecosystem'.

Recently, national and international attention focused on the ETGG law and more especially Article 173. While attention has most recently focused on climate-related issues, French reporting requirements address broader ESG issues and recent developments on climate change are part of a broader twenty-year process. Throughout this process, an underlying dynamic can be observed: each successive decision aims to be a continuation and build on the strengths – or correct the failure – of previous ones. Moreover, freedom is given in how actors can act to fulfil their respective obligations.

France thus appears to follow a model of public action where the role of the State is to ensure the proper functioning of the financial system and its ability to deliver an efficient allocation of resources. This

occurs first by fostering the provision of better information on SRI, ESG and climate-related issues to financial actors gradually through reporting requirements for both financial actors, as well as companies underlying held assets. In some instances, where necessary, targeted actions are taken to improve the allocation.

In this perspective, this is coherent and compatible with increasingly dominant perceptions of the role of the State in fostering the emergence of a sustainable economic model and financial system to service its needs. Seeing this as excessive public intervention is misleading. Through a supervisory-based approach, the State currently focuses on mandating the reporting and the provision of information. This strategy has the advantage of establishing guidelines and thresholds rather than intervening directly at the methodological or procedural level. In turn, it is then up to each financial actor to define the corresponding materiality and relevance, and if necessary, develop an adequate strategy to manage potential risks. This allows institutions to identify the methods of compliance that best fit their business model and in the end develop best practices.

Over time, these reporting requirements have in general become acceptable to private actors and have fostered both expertise building among actors and the emergence of an ecosystem of institutions focusing on these topics. The required reporting is key to avoid information asymmetries and enable a full appraisal of risks which can then lead to a global allocation of capital that is consistent with the transition towards a sustainable, resilient and low-carbon economy.

The adoption of Article 173 of the Energy Transition for Green Growth Law can be seen as the direct consequence of the existence and dissemination among actors of such an expertise. This dissemination is also a prerequisite for the perpetuation of a self-sufficient ecosystem as the success of the current regulatory framework will be based mainly on non-binding 'soft law' principles.

The balance between a comprehensive and well-designed, thus impactful, regulation and its acceptability, or its usefulness, is always difficult to strike and perhaps even harder to maintain. The French strategy has been to take small, incremental steps to give enough time to all actors to appropriate, learn and ramp up implementation.

The evolution of the framework will face many challenges. The years 2016 and 2017 will be crucial to the success and future of these dynamics as financial institutions will learn to comply with the new regulatory framework. Further guidance is also necessary from the State – for example precisions are expected on the implementation methodology of climate-related stress test for banks.

More broadly, it is important to remember that scaling up climate and more broadly sustainable finance cannot be achieved single-handedly by improved practices in the financial sector. Capital will seek returns and it appears essential that the implementation of sustainable, coherent and ambitious 'demand-side' policies occurs that improves the risk/return profiles of climate-related projects to make them bankable or financially attractive. In short, efficient climate policies need an efficient financial system that fully fulfils its pivotal role in the economy.

Finally, in a post-COP21 period, climate change may not remain at the top of the agenda. Therefore, it will be a positive sign if financial institutions continue to actively pursue the integration of climate-related and other sustainability issues beyond December 2015, especially at the highest level of management as it has been the case in the last months. It would support and give legitimacy to individuals in charge of better integrating ESG issues in the financial sector. Furthermore, lessons based on the development of the French ecosystem could be useful to other countries also aiming at better integrating sustainability issues in their financial system.

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