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

EXECUTIVE SUMMARY

France's Financial (Eco)system

IMPROVING THE INTEGRATION OF SUSTAINABILITY FACTORS

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The Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it published its final report 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

This study was completed by Romain Morel and Ian Cochran. Significant input was provided by Nick Robins during steering committee discussions.

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The authors take sole responsibility for findings or ideas presented in this report as well as any errors or omissions.

FRANCE'S FINANCIAL (ECO)SYSTEM

IMPROVING THE INTEGRATION OF SUSTAINABILITY FACTORS

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

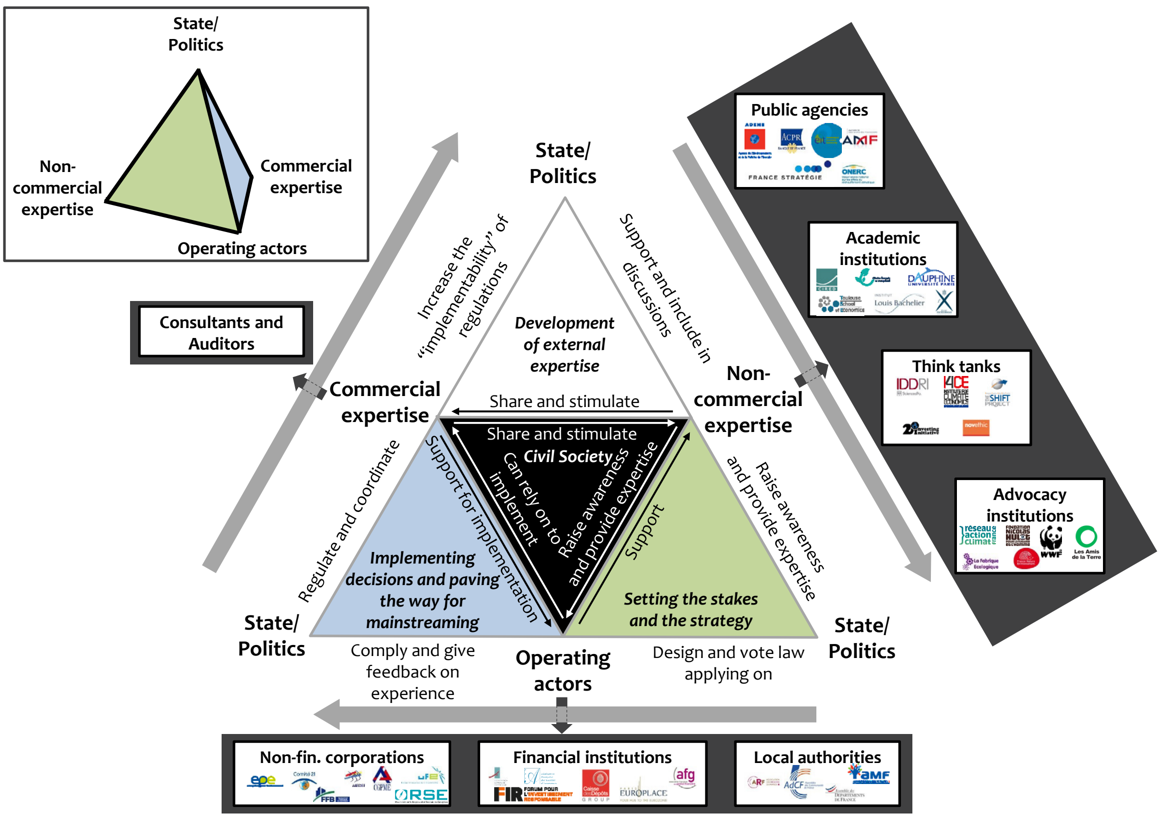
The next steps and challenges ahead for the French ecosystem are threefold:

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

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