

Fair economy. Better world.



Time for action

An analysis of the limited progress to date in making the financial system more sustainable and responsible, with policy recommendations to change behaviours.

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with John Lappin, Professor Robin Jarvis
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Financial Inclusion Centre

Further information

This report can be downloaded free of charge from the FPF website

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Friends Provident Foundation

Friends Provident Foundation is an independent charity that makes grants and uses its endowment towards a fair and sustainable economic system that serves people and planet. We connect, fund, support and invest in new thinking to shape a future economy that works for all.

Since 2004, we've pioneered the creation of fair economy for a better world. Already, we've helped improve access to financial services for people who were once excluded, and supported the development of resilient economic communities across the UK.

We're a catalyst for wider change, making an impact through continuous experimentation and shared learning. And we do all we can to embody the change we want to see. We invest in great social enterprises, and use our money in line with our values.

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Financial Inclusion Centre

The Financial Inclusion Centre is an independent, not-for-profit policy and research group. Its mission is to promote a financial system and financial markets that work for society. The Centre works at two main levels.

Promoting system-level change. We undertake research and develop policy to promote sustainable, resilient, economically and socially useful financial markets that: benefit the environment; encourage responsible corporate behaviours and create a positive social impact; and efficiently allocate long-term financial resources to the real economy.

Ensuring households' core financial services needs are met. We promote fair and inclusive, efficient, well-governed and accountable, properly regulated financial services that meet households' core financial needs. To do this, we undertake research into the causes of market failure in the sector, formulate policies to address that market failure, develop alternative solutions where the market cannot deliver and campaign for market reform.

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Foreword

Sustained record low interest rates, the driving down of bond yields, and quantitative easing deployed in response to the 2008 financial crisis still distort the behaviours of financial markets, financial institutions and households. It will be some time, if ever, before market conditions are 'normalised' – before interest rates and bond yields return to typical pre-crisis levels. The 'new normal' will be with us for some time.

Our concern at the Financial Inclusion Centre is that the main players (policymakers, regulators, financial institutions, think tanks and consumer groups) have been slow to appreciate the consequences of the 'new normal' for savings, investments and pensions, as well as for the allocation of financial resources to the real economy.

The new environment creates not just risks. It equally creates opportunities for the reform of financial markets so they can work better for the economy and society. Of particular interest to us is what we term finance for good – sustainable, responsible and social impact activities, collectively SRI. These activities include: lending and investment that supports environmentally and socially responsible corporate behaviour; providing long-term finance to real economy firms; and support for social impact goals (such as channelling long-term funding into alternative lending to benefit financial inclusion).

In the aftermath of the crash, financial institutions and households have looked to alternative investments and financial products to generate decent returns as a way of offsetting the low yields on deposits and bonds (the 'search for yield'). This ought to have been a promising environment for finance for good, given the amount of financial resource available in total in financial markets and savings, investment and pensions portfolios. But, although it has clearly moved up the agenda, and there has been some growth, this has yet to translate into a significant increase in financing, either by banks or investors.

This led us to undertake a major project, with funding from the Friends Provident Foundation, to examine the available data on finance for good, and understand the factors that are limiting its growth. Our findings and policy recommendations are published in this new report: Time for action.

Some targeted regulation is undoubtedly needed, but regulation is far from the only answer. Civil society groups and the financial sector itself have a golden opportunity to contribute to the reform of financial markets. Campaigning groups should work to create more public demand. They must do more to encourage ordinary citizens to use their pensions, investments and savings to demand behavioural change in financial markets. However, the infrastructure needed to support greater finance for good – quality data and research, suitable financing vehicles and financial products – is still woefully underdeveloped.

Reliable data and research on finance for good is limited, compared to mainstream financial activities such as investments and loans. An industry of market analysts, risk analysts and information providers, along with reasonably consistent standards on information disclosure, help banks, institutional and retail investors make informed decisions about risk and returns. But we are very far from that in sustainable, responsible and social impact finance.

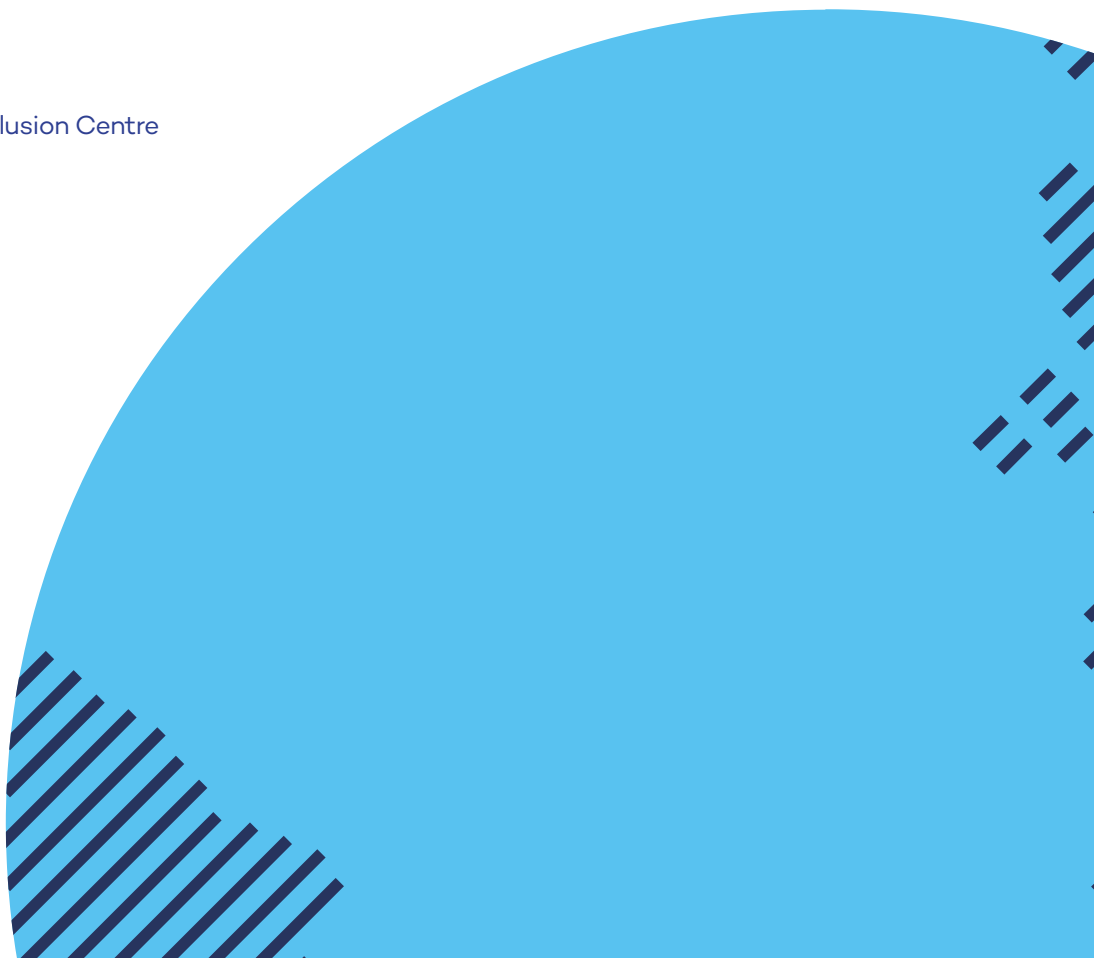
The onus is now on civil society organisations to work with the industry to improve the volume and quality of the data and research and develop suitable products. If they don't, it is difficult to see finance for good achieving scale.

The culture of short-termism that prevails in financial markets is not conducive. Too many see finance for good as a secondary issue rather than a natural ingredient in financial decision-making. It does not conflict with any duty to maximise financial returns. On the contrary, failure to hardwire SRI into financial decisions creates huge risks to loan and investment portfolios and will reduce returns in the long term. There is a unique opportunity now for civil society organisations to 'educate' financial decision-makers including banks, institutional and retail investors, pension fund trustees and other influential gatekeepers such as pension fund and investment consultants.

The financial sector is vitally important to the UK economy. The City has recovered faster from the crash than the rest of the country. But, the sector has experienced a crisis of public trust and confidence – and rightly so. Questions have been asked about the fundamental social utility of the sector. The credibility of, and trust and confidence in, the sector must be restored and maintained. The nature and the scale of the SRI challenges facing the UK presents an opportunity for the financial sector to work with civil society groups to demonstrate its social and economic value.

We hope readers find this report useful, interesting and – what is more – actionable. We are grateful indeed to Friends Provident Foundation for supporting the project and to all the experts who helped us with our research. We look forward to bringing policymakers, regulators and civil society together with the financial sector to accelerate its positive contribution to meeting the economic, environmental and social challenges we face today.

Malcolm Hurlston, CBE
Chairman, The Financial Inclusion Centre



Summary

Introduction

- The financial crisis of 2008 shook financial markets to the core. We escaped a 1930s-style depression through interventions on a scale previously seen only at times of crises such as the Napoleonic Wars, the two World Wars, and the Wall Street Crash. Quantitative easing (QE) and slashing of interest rates by the Bank of England were deployed to stop critical financial institutions and infrastructures failing.¹
- As it stands, 25 per cent of global bonds have a negative yield.² The consensus is that it will be some time before financial markets are 'normalised' – that is, before interest rates and bond yields return to typical pre-crisis levels (if they ever do).
- With this in mind, this project set out to answer two main questions:
 - How have financial institutions and households behaved in the low-rate, low-yield environment? Specifically, to what degree have financial institutions and households increased the amount of finance (investment and loans) directed to economic activities that: have a positive impact on the environment; promote responsible corporate behaviours; or have a positive social impact. We term this sustainable, responsible and social impact (SRI) finance.³ The evidence is summarised in Section 1 of this report and covered in more detail in a separate Annex that is available from the Financial Inclusion Centre (www.inclusioncentre.org.uk).
 - What factors limit the amount of financial resources going into SRI activities? The results are summarised in Section 2 of this report and covered in more detail in the Annex. From this assessment, in Section 3 we set out policy recommendations designed to channel more public and private resources into SRI activities.

The evidence on SRI financing (Section 1)

Post-crisis saw a 'flight to quality' and a 'search for yield' in financial markets

- We saw a flight to quality, as financial institutions increased their holdings in safe, low-yielding assets such as government bonds (gilts). At the same time, there has been a search for yield to offset the low yield on safer assets. Financial institutions invested more in complex, higher risk alternative assets (such as hedge funds or structured products). Households invested large sums in the buy-to-let property sector, switched money from safer employer pension schemes and annuities, and invested in complex financial products to compensate for low rates on savings accounts (see Annex).

The prize for greater SRI financing is significant given the size of UK financial markets (p. 17)

- The total value of assets held by financial institutions⁴ in the UK is around £20 trillion. Households have £12.8 trillion in net wealth.⁵ Even a small fraction of those assets allocated to SRI ventures would be an injection of significant resources into the sector. But, have financial institutions and households invested in or lent more to SRI when searching for better returns?
- To get a fuller picture, we studied the evidence on: investor attitudes to SRI; the extent to which SRI has been incorporated into investment strategies; changes in asset allocation by institutional investors; the size of the green bond market; direct investment and lending to SRI activities; bank lending to SRI; the role of the Bank of England; citizen-investor attitudes and behaviours; and economic activity in the sector.

SRI has undoubtedly risen up the agenda, attitudes have become more positive (p. 18)

- Institutional investor attitudes towards SRI have become more positive, with material increases in the proportion of institutional investors saying they consider the opportunities created by climate change. Recent research found two-thirds of pension scheme members favoured investing their pension savings in a sustainable way.

But there is a long way to go before SRI is mainstreamed into financial markets (p. 19)

- A number of surveys and research papers have found that a minority of institutional investors, pension schemes and investment professionals actively incorporate climate risk in their investment decision process, or provide specialist training on how to incorporate environmental, social and corporate governance (ESG)⁶ criteria in the investment decision-making process.
- A recent survey of institutional investors in 28 countries found the UK scored 25th out of 28 on the importance placed on environmental impacts when making investment decisions. The UK scores slightly better on social outcomes – 23rd out of 28.
- There is now £15.9 billion invested in ethical retail investment funds in the UK. But, this is just 1.4 per cent of total assets under management.
- It is difficult to get precise data on the total amount of investment in SRI in the UK. But, estimates put the value of global funds managed with explicit ESG criteria at \$360 billion – equivalent to just 0.4 per cent of total global assets under management (estimated to be worth \$85 trillion). The value of ESG assets under management has actually grown at a slower rate than mainstream assets under management.
- Strikingly, large global asset managers increased holdings in thermal coal by 20 per cent from 2016 to 2018. Moreover, shares of energy intensive industries made up 36 per cent of the value of the FTSE 100 Index in 2018, up from 30 per cent in 2015. It is estimated that the UK emits 1 per cent of global CO₂. But fossil fuel companies listed in London are estimated to be responsible for 15 per cent of potential global CO₂ emissions.

UK company boards are not coming under sustained pressure from shareholders to change the way they run their operations (p. 20)

- Recent research found that a minority of FTSE 100 companies had assessed climate risks in supply chains, undertaken climate scenario analysis, and adopted climate mitigation practices. Environmental risks were included in the key performance indicators (KPIs – which influence organisational priorities and executive remuneration) of a minority of firms in the energy, industrial, and information technology (IT) sectors in the wider FTSE 350 Index.

Green bonds make up a small fraction of the huge global bond markets (p. 21)

- The total value of global bonds described as ‘climate-aligned’ was estimated to be \$1.45 trillion in 2018 – just 1.45 per cent of the total global bond market estimated to be \$100 trillion. The size of the dedicated green bond market (with finance earmarked for projects with identifiable environmental benefits) was estimated to be \$389 billion (26 per cent of the total green bond market). Sixty per cent of green bonds were issued by state agencies.
- A recent Environmental Audit Committee report found that only \$3.9 billion of green bonds had been issued for domestic UK use compared to \$41 billion in France, and \$24.9 billion in Germany – both of which have smaller financial centres.⁷ The UK does not make it into the top 10 countries.

Direct investment in and lending to green projects in the UK remains low (p. 22)

- The UK should be investing around £22 billion a year into clean energy projects to meet its carbon budgets. But in the 10 years to 2017 the UK did not once meet the target, and the amount fell recently. The number of deals and amount of money invested in clean technology (cleantech) seems ⁸ to have actually fallen between 2012 to 2017, at a time when venture capital deals in the wider economy rose by 50 per cent.
- Reliable data on bank lending to green projects is difficult to find. But one estimate puts the value for the period 2017–18 at \$1.63 billion (£1.24 billion). As a comparison, banks lent an average of £22 billion each month to non-financial corporations in 2017 and 2018. Even the Bank of England's QE programme seems to have been skewed towards high carbon sectors of the economy.

The level of economic activity in the green sector has been disappointing (p. 23)

- The number of businesses in the low-carbon and renewable energy sectors fell by 16 per cent from 105,500 in 2015 to 88,500 in 2018. Turnover is up by £4 billion in real terms over the same period. But, in 2018, it still represented just one per cent of total economy turnover same as it did in 2015.

The conclusion is that, while SRI has clearly moved up the agenda, the amount of resources allocated to SRI assets remains very low

- The level of SRI assets held in the sector by financial institutions and households remains very low – particularly seen against the amount invested in alternatives (such as hedge funds or private equity), the amount banks have lent to other parts of the financial system or to the property market, and the amount households have invested in the buy-to-let property market. The question we now turn to is: why this has been the case – what are the factors that limit growth in SRI financing?

The factors that constrain growth in SRI finance (Section 2)

- There are daunting barriers to overcome if we want to see the necessary level of financial resources allocated to SRI. We categorise these into: factors specific to SRI; institutional factors; the impact of legislation and regulation; information and perception factors; the culture of short-termism; and other market factors.

The specific nature of SRI projects means they can be unattractive to risk averse financial institutions and markets where short-term thinking still dominates (p. 25)

- Direct SRI investments can have comparatively long payback periods – often between 7–12 years. In contrast to mainstream assets such as equities and bonds, which are easily traded on public markets, ⁹ it can be difficult to exit an SRI investment.
- SRI assets are considered more risky than conventional assets, which means that financial institutions will expect higher returns to compensate – returns that may take some time to materialise (see above).

Institutional constraints reduce the viable pool of resources available for SRI (p. 25)

- A number of factors constrain financial institutions' ability to finance SRI including: the type of liabilities institutions face; tolerance to risk; and the need for liquidity.

- Defined benefit (DB) pension schemes provide a good example. DB schemes still make up the largest share of employers' pensions by value, but most are now closed to new members, and most now have negative cash flows (more money going out of the scheme than coming in). DB schemes need to hold large amounts of assets in less risky or liquid assets such as gilts and cash. The same applies to insurance companies, which need to hold low risk assets to pay out insurance claims.

Financial regulation or misconceptions about legal duties can constrain willingness to finance SRI projects (p. 26)

- Prudential regulation seeks to minimise the risk that financial institutions go bust, which would result in undertakings to pension scheme members/investors/depositors/policyholders not being honoured. Financial institutions must identify risks and hold a proportion of funds in 'safe' assets. For banks and insurance companies, this can have the effect of reducing profits, which deters them from financing activities considered to be riskier.
- Misconceptions about fiduciary duty have been a barrier to pension funds investing in SRI. The concern was that investing in SRI is at odds with pension scheme trustees' duty to maximise returns for scheme members. Government has since clarified that this is not the case. Nevertheless, there is still much work to do to reassure pension fund trustees that SRI can be an appropriate asset class for pension schemes.
- Gaps in consumer protection and increased awareness of SRI means that less sophisticated investors are vulnerable to the mis-selling of supposedly 'green' financial products. During the course of the research, we found examples of 'green' bonds offering 9 per cent per annum, even as high as 18 per cent per annum. High risk bonds are often not covered by the same financial regulation and redress schemes as mainstream investment products. A mis-selling scandal involving green bonds could undermine confidence and trust in SRI.

There are major information and perception barriers to growth in SRI (p. 27)

- Information barriers include: the lack of clear definitions and criteria for determining whether an economic activity complies with SRI goals; limited transparency on SRI compliance; lack of trustworthy benchmarks and ratings to judge how well loans and investments comply with SRI criteria; and limited data and research on risks and rewards associated with SRI assets. The amount of effort and cost required to identify potential SRI financing opportunities can deter financial institutions.
- Concerns that SRI assets do not produce decent investment returns are still ranked as one of the top barriers to greater investment by pension funds, despite compelling evidence that there is a strong case for SRI. But, that evidence is either ignored or not appreciated by potential investors.

There is a limited market infrastructure to support SRI but promoters face a Catch-22 situation (p. 28)

- As well as information barriers, there is a limited market infrastructure to support growth in SRI. This includes: a limited primary and secondary market infrastructure for raising capital and trading of SRI assets; and a lack of collective investment vehicles for managing the risk of investing in smaller scale SRI projects in a cost-effective manner.
- But, promoters of SRI face a Catch-22 situation. Sufficient resources are unlikely to be committed to developing the necessary research base and infrastructure unless those asset classes become more popular, and yet SRI is unlikely to become mainstream without the necessary research and supporting infrastructure. This is a particular problem for smaller or early stage SRI ventures.

The dominant culture of short-termism and shareholder value in financial markets is at odds with the long-term approach needed for SRI (p. 29)

- Financial market short-termism is at odds with the long payback periods associated with direct investment in SRI; and is a constraint on listed companies who wish to spend time and money 'greening' their operations.
- Greening the UK economy will require significant investment in research and development (R&D). But the UK has one of the lowest levels of spending on R&D (as a percentage of GDP) of the major economies. The UK has a significantly lower rate of corporate investment compared to European Union (EU) counterparts. The emphasis placed on shareholder value appears to lead to lower levels of investment and holds back innovation.

There is a limited availability of suitable SRI ventures (p. 30)

- The limited availability of viable SRI ventures creates a natural barrier restricting the amount of SRI finance that will be channelled into economic transformation.

Other market factors need to be addressed (p. 30)

- The value of passively managed, or index, funds (which track the performance of indices such as the FTSE All Share Index¹⁰) grew from £59 billion in 2012 to £165 billion in 2017 – now representing 25 per cent of total UK assets under management in the UK. Passive funds automatically include shares of companies from energy-intensive sectors in their portfolios. Moreover, these funds are not actively managed, so fund managers do not seek out potential SRI opportunities not listed on major stock markets.
- Investment consultants and financial advisers act as key gatekeepers on investment decisions. Investment consultants influence investment and asset allocation decisions on £1.6 trillion of pension assets (out of a total of around £2 trillion). Similarly, nearly 80 per cent of money managed on behalf of retail investors is done on an advised basis. Persuading these influential gatekeepers of the merits of SRI will be a priority.

Policy interventions to support greater SRI financing (Section 3)

- There are a number of civil society and market-led initiatives designed to promote greater use of SRI. These are important, but they are unlikely to go far enough to change minds and behaviours, and to mainstream SRI into financial markets. We make 41 specific policy recommendations grouped around core policy objectives. The aims of the recommendations are to:
 - raise awareness of and promote confidence and trust in SRI assets;
 - increase the availability of good-quality SRI information, research and analysis;
 - encourage investors, lenders and intermediaries to become more engaged with SRI;
 - embed SRI into decisions made by lenders, investors and intermediaries;
 - better align financial market behaviours with SRI goals;
 - create a more supportive regulatory architecture; and
 - ultimately, increase the resources allocated to SRI by the public and private sectors.

Raising awareness of SRI, enhancing the knowledge and skills of stakeholders (p. 33)

- Stakeholders should undertake research to establish understanding of SRI, including perceptions of risk and reward, and develop a programme to enhance SRI literacy amongst investors, lenders, pension trustees and citizen-investors. A centralised resource for educational materials on SRI should be created.
- The objectives of the Money and Pensions Service should be amended to promote awareness of and improve consumer knowledge of SRI issues.

Increasing the availability of SRI information, research and analysis (p. 34)

- Stakeholders should collaborate on developing and promoting a central repository of information, research and risk analysis on SRI. This should be accessible to financial institutions, regulators, pension trustees and citizen-investors.
- Building on the proposed EU taxonomy for SRI, UK stakeholders should prioritise the development of a UK SRI classification system. The aim is to help regulators, lenders and investors to identify more easily the degree to which economic activities, sectors of the economy and individual listed and larger private companies comply with SRI goals. This should be overseen by the Financial Conduct Authority (FCA). To address the risk of 'greenwashing',¹¹ stakeholders should develop a new SRI compliance rating system based on the new taxonomy. This should be published on an accessible, central database. For retail investors, a single, easy-to-understand SRI rating label should be developed and included in comparative information tables.

Improving and maintaining confidence and trust in the SRI sector (p. 35)

- SRI funds/financial products, and firms that provide and promote those funds/products, should be subject to the same FCA regulatory regime as mainstream financial products and covered by the Financial Ombudsman Service (FOS), and Financial Services Compensation Scheme (FSCS).
- 'Green supporting' factors currently being considered by the EU to encourage greater levels of sustainable finance could increase the risk of greenwashing by financial institutions and could undermine confidence and trust in SRI. Post Brexit, the UK should use the opportunity to introduce deterrence factors for 'brown assets' – that is, penalties for investing in or lending to economic activities that damage SRI goals.

Changing minds and behaviours (p. 36)

- Better information will be necessary, but not sufficient. Financial institutions will need to be compelled to act. Government should require pension fund trustees to formally engage and consult with pension scheme beneficiaries on how SRI issues are factored into investment strategies. Trustees should be required to explain and justify decisions that are contrary to scheme beneficiaries' views. For contract-based pension schemes, the FCA should require Independent Governance Committees (IGCs) to oversee and report to scheme members how scheme managers factor in SRI, and consider scheme members' views.
- Financial institutions¹² should be mandated by regulators to assess how lending, investment and insurance decisions contribute to SRI goals; and publicly report the results of those assessments using the SRI classification mentioned above.
- Government should mandate reporting by listed (and other major private) companies on compliance with SRI goals, rather than rely on the 'comply or explain' approach.

Aligning interests and incentives in the financial system (p. 37)

- Current behaviours in financial markets are not sufficiently aligned with SRI goals. Campaigners should develop and promote a new SRI toolkit to give pension fund trustees, investment consultants and financial advisers the confidence to embed SRI in investment strategies. This should include advice on how to: move away from quarterly reporting by fund managers; challenge executive remuneration practices that promote short-termism; challenge behaviours in corporate supply chains that contravene SRI goals; select alternative benchmarks; and incentivise SRI supporting strategies.
- Government should consider new tax structures to: encourage long-term investing and deter short-term speculation, including a financial transactions tax; encourage early stage SRI financing; encourage long-term investment in R&D with a focus on climate-related projects and cleantech; and deter executive remuneration schemes based on short-term corporate performance.

Developing a suitable financial market infrastructure to support the development of SRI (p. 38)

- Stakeholders should develop collective investment and lending schemes to allow institutional and retail finance to be channelled into early stage/small-scale SRI ventures in a way that minimises costs and diversifies risks. Stakeholders should work with investment industry experts to develop a range of SRI index funds.
- There is a strong case for a national SRI investment bank to finance early stage SRI ventures and take equity stakes in established ventures. The British Business Bank should also be given a specific new objective to finance SRI projects.
- Government should take advantage of its ability to borrow funds from financial markets at much lower cost than private sector financial institutions and issue green sovereign bonds to finance larger scale SRI initiatives. National Savings and Investments (NS&I) should offer green finance and social housing bonds to allow citizens to play a role in financing SRI. Government should support local authorities in developing and issuing community green finance and social housing bonds.

Creating the appropriate regulatory architecture, governance and objectives (p. 39)

- The Bank of England should be given a new statutory objective to promote financial market behaviours that contribute to economic and environmental sustainability.
- The FCA and Prudential Regulation Authority (PRA) should be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objective.
- The FCA should be given responsibility for overseeing how financial institutions, listed companies and larger private companies disclose compliance with SRI criteria. Reporting on SRI compliance should be made a statutory requirement rather than voluntary, with appropriate sanctions for non-compliance with reporting standards. The recommendations set out by the Task Force on Climate-Related Financial Disclosures (TCFD)¹³ form a useful basis for a new system of reporting.
- The PRA is establishing a Climate Financial Risk Forum¹⁴ co-chaired with the FCA to build intellectual capacity and share best practice on issues relating to climate-related financial risks. This is welcome. But, it is not enough. Government and the Bank of England should establish a Financial Sustainability Committee (FSC) along the lines of the Monetary Policy Committee (MPC), which sets interest rate policy. The new FSC should take responsibility for the Bank's new statutory objective described above and coordinate the work of all the regulators involved in managing climate-related risks – the Bank of England, PRA, FCA and The Pensions Regulator (TPR). The FSC should publish an annual report on its activities plus a wider triennial review on progress against its objectives. The FCA, PRA and TPR should also publish an assessment in their annual reports on how their activities have contributed to the objective of the new FSC.

Increasing the supply of viable SRI opportunities (p. 40)

- Along with creating a new infrastructure and reforming financial regulation to support the development of SRI, we argue for a government-led strategy to green the economy. Building on the work of the Committee on Climate Change (CCC),¹⁵ government and relevant regulatory authorities should undertake a ‘transformation audit’ of the main economic sectors to assess the contribution each sector has made to the greening of the economy; and develop a transformation action plan for each sector.
- Government should establish a single agency to coordinate this strategy – either give responsibility to the Environment Agency or expand the role, powers, and resources of the CCC. This new agency, along with the National Audit Office, should develop new metrics to judge the performance of each sector, and publish annual updates and a formal triennial review of progress made against the transformation strategy.

The impact of Brexit (p. 41)

- It is not yet clear how Brexit will affect initiatives to develop SRI financing. It very much depends on which form of Brexit we see. Therefore, policymakers and civil society should collaborate on analyses to assess the implications of Brexit on UK initiatives to promote SRI. In particular, this should consider the effect if the UK is no longer a key player in the European Union’s ambitious Capital Markets Union project and Action Plan for Financing Sustainable Growth.¹⁶

Introduction

The financial crisis of 2008¹⁷ shook the financial system to the core. We escaped a 1930s-style economic depression through interventions by policymakers on a level previously only seen at times of crises such as the Napoleonic Wars, the two World Wars and the Wall Street Crash. 2008 was that serious.

In the UK, quantitative easing (QE) and the slashing of interest rates by the Bank of England were deployed to stop critical financial institutions and infrastructures failing.¹⁸ The consensus is that it will be some time before conditions in financial markets are 'normalised' – that is, before interest rates and bond yields return to typical pre-crisis levels (if they ever do).¹⁹ With this in mind, this project set out to answer two main questions:

- How have financial institutions and households searched for returns in the low rate, low yield environment? Specifically, have financial institutions and investors increased the amount of resources allocated to financing²⁰ sustainable, responsible and social impact (SRI) activities? The evidence is summarised in Section 1 of this report and covered in more detail in the Annex.
- What are the barriers that limit the financing of SRI activities? The results of that assessment are summarised in Section 2 of this report and covered in more detail in the Annex. From this analysis, we have developed a set of policy recommendations designed to promote greater levels of SRI financing. These are set out in Section 3 of this report.

Methods

To answer those questions, we:

- analysed published data on asset allocation by institutional investors such as pension funds and retail investors, and bank lending, pre and post financial crisis;
- undertook a literature review of policy and academic papers on what drives financial market behaviours;
- interviewed experts to get their views on the barriers and constraints that limit the financing of SRI activities. We are very grateful to those experts who helped us with these interviews.

Definitions

There are a number of definitions and terms used in this field. We use the term sustainable, responsible, and social impact (SRI) to cover finance that aims to have a positive impact on the environment, and promotes responsible corporate practices or a positive social impact.

This can be achieved by adopting:

- defensive policies and strategies: avoiding or screening out investments or loans to economic activities that do not comply with SRI criteria;
- positive policies and strategies: actively seeking out economic activities that meet SRI criteria by contributing to environmental or social impact goals
- influencing policies and strategies: where investors²¹ or funders retain a stake in company or venture and try to exert a positive influence on its activities.

These strategies can be implemented through:

- investing in shares and bonds of established corporates listed on stock markets; or
- direct investment or lending to SRI activities – financing either established companies, or new/early stage ventures.

This report considers all these forms of SRI financing, but has a particular interest in identifying the barriers that limit the financing of new or early stage ventures.

Note we do not cover the 'G' part of ESG (corporate governance)²² – although some of the data will include this, as it is not always possible to split out each part of ESG.

Where does financial market reform fit in?

Addressing financial market failures alone will not be enough to tackle major environmental and social challenges. For example, averting climate catastrophe will need:

- a green transformation in key sectors of the economy;
- major reforms to the financial system and changes in the behaviours of financial institutions to finance that green transformation and to deter economic activities that harm the environment;
- changes in patterns of consumption by consumers; and
- reforms to global governance (tackling climate change really is a global issue).



The focus of this report is on the contribution the public and private financial sector, financial institutions and individual financial consumers can make in tackling environmental and social issues.



Section 1

The evidence on SRI financing

Before assessing the evidence on how much investment and lending has gone into SRI activities, it is worth reminding ourselves of the size of the UK financial system.

The UK asset management industry is the second largest in the world, and the largest in Europe; the UK banking sector is the fourth largest in the world, and the largest in Europe; the UK insurance industry is the fourth largest in the world, and the largest in Europe

According to the Investment Association, the total assets managed in the UK are £9.1 trillion.²³ On top of the £6.9 trillion managed by Investment Association members, there are £479 billion of private client assets, commercial property managers manage £490 billion, hedge funds £285 billion, and private equity £250 billion. Association of British Insurers members manage £1.84 trillion in assets.²⁴

Banks are a potentially important source of loans or debt finance for the sector. The total value of assets held on the balance sheets of UK banks is £8 trillion.²⁵

Overall, it is estimated that the total size of assets owned by all types of UK financial institutions²⁶ is closer to £20 trillion.²⁷ UK households have £12.8 trillion in net wealth.²⁸ Even a comparatively small increase in the share of investment made into SRI could have a major impact.

It is hoped that pension funds will play a significant role in funding SRI, but structural changes in the sector may limit its role in practice

The UK pension fund sector is estimated to be £2,400 billion.²⁹ One of the most important factors influencing behaviours in the market is the type of pension scheme – defined benefit (DB) or defined contribution (DC).³⁰ The way risk is shared between employers and individuals differs between defined benefit and defined contribution schemes. This will have an influence on the type of assets held within a scheme.

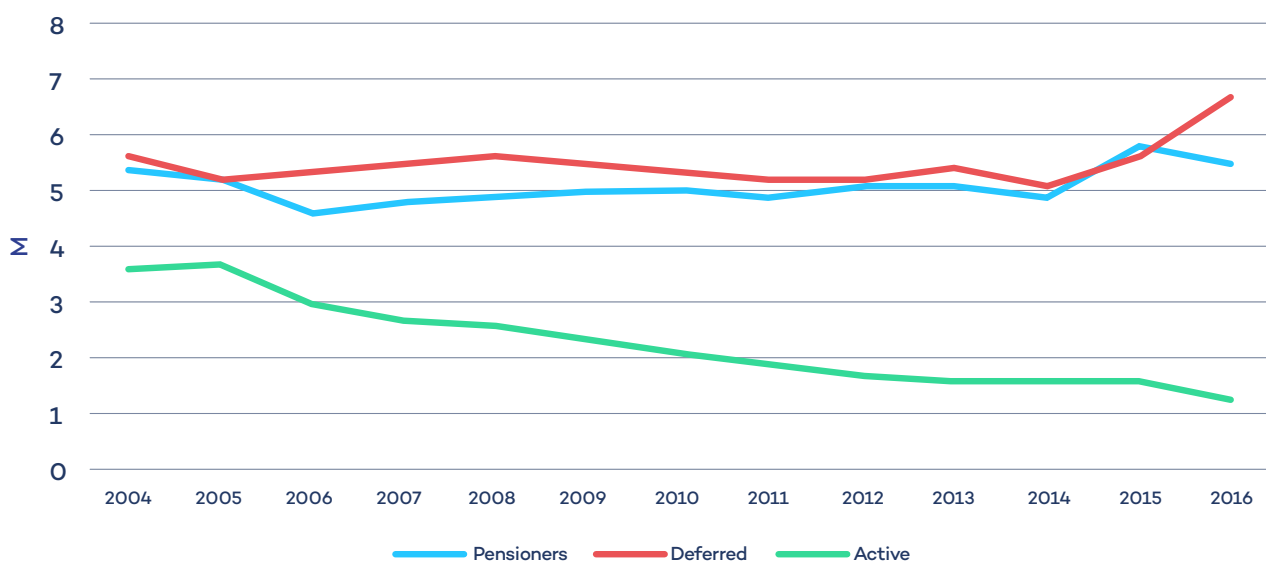


Figure 1: Active members of defined benefit schemes continue to decline

Source: Djuna Thurley and Federico Mor, Defined Benefit Pension Schemes: 2018 White Paper, Briefing Paper No. CBP-8219, 2018, House of Commons Library, <http://researchbriefings.files.parliament.uk/documents/CBP-8219/CBP-8219.pdf>

DC schemes grew by more than twice the rate of DB schemes over the 10 years to end 2015 (7.1 per cent per annum compared to 3.4 per cent) and are now the dominant form of pension scheme (in terms of numbers).³¹

In 2018 in the private sector, only 0.7 million of 1.1 million DB (active) members were in sections of schemes that were open to new members compared with 9.8 million of 9.9 million DC members.³² A recent survey found that only 4 per cent of 230 large DB schemes were still open to new members.³³ But, it is worth noting that, based on the value of assets, it is estimated that the employers pension market is still split 82 per cent defined benefit, and 18 per cent defined contribution.³⁴

Cash flows are also important. Fifty-six per cent of defined benefit schemes currently have negative cash flow (more money is going out than coming in), and of the rest, 83 per cent are expected to within 10 years.³⁵ This will constrain their ability to invest in long-term, higher-risk ventures (some of the defining characteristics of SRI ventures).

So, even though pension funds have £2.4 trillion in assets, institutional constraints such as those outlined above mean that the viable pool of pension fund assets for SRI is much smaller than this.

Key data on SRI financing

We will now look at the data on how much has been lent to and invested in SRI activities. Fuller data can be found in the Annex.

Before doing so, it is worth pointing out that analysts estimate that \$93 trillion of investment in green technology and transformation projects is required across the global economy by 2031 (over \$6 trillion a year) to stay within the 2 degree world.³⁶ Even this huge sum may be a significant underestimate, as experts now say that global temperature rises should be kept below 1.5 degrees.³⁷

Attitudes to SRI

There are encouraging signs that investors (institutional and retail) are looking more positively towards SRI

A recent survey found that 68 per cent of global investors planned to increase their exposure to low carbon based investments (93 per cent for European investors). The figure for social impact investments was even more encouraging – 73 per cent of global investors said they planned to increase social impact investment.³⁸

Another recent survey shows a smaller but nevertheless material jump in the number of investors considering the investment risks and opportunities created by climate change — from 5 per cent to 17 per cent in 2018.³⁹ But, this still means that 83 per cent of those surveyed were not considering the risks and opportunities.

Recent academic research found that two-thirds of pension scheme members favoured investing their pension savings in sustainable way.⁴⁰ But, given the paucity of good data on the subject, it is not clear to what degree these preferences have translated into action on the part of pension scheme members (for example, demanding a change in investment strategy) or how many pension scheme trustees factor in scheme members' preferences into investment strategy and decision-making.

But the UK appears to be lagging in terms of level of interest in SRI

A recent survey asked investors in 28 countries how much importance they placed on positive environmental impact when making investment decisions. The UK scored joint 25th out of 28. When it came to positive social outcomes and social responsibility, the UK scored slightly better – 23rd out of 28.⁴¹

Interest in social impact initiatives remains low

Interest in other social impact ventures, such as microfinance and social housing, appears to be even lower (although good recent data is hard to come by). A survey of 47 pension funds found that only five intended to invest in microfinance and 13 in social housing in the foreseeable future.⁴² The authors concluded that although interest was growing, impact investing was unlikely to become mainstream.

SRI strategies

But the data suggests that, when it comes to the hard-nosed decisions about where to invest money, positive attitudes are not embedded into the investment strategy and decision-making process

SRI investment strategies align investment portfolios to environmental and social goals. Recent research by ShareAction found that only two out of 15 defined contribution pension schemes⁴³ of FTSE 100 companies (the largest companies on the UK stock market and representing one million savers) had default schemes explicitly constructed to reduce exposure to climate-related risks.⁴⁴ Ten corporations refused to participate in the survey. While eight of the 10 employer-sponsored trusts had discussed climate-related risks with their investment consultants, only two of those trusts had added climate-related risks to their scheme's risk register, and only three had conducted scenario analysis (where the impact of different climate scenarios are modelled). The majority of employer-sponsored trusts delegate these stewardship activities to their asset managers and exercise limited oversight of how climate risk is managed.

Only a quarter (27 per cent) of respondents from another major survey of institutional investors said sustainability has a significant influence on their investment decision-making.⁴⁵ One-third (32 per cent) said it had little or no influence, and 41 per cent said it had a moderate influence.⁴⁶

A major academic study reported that less than one quarter of investment professionals consider extra-financial information frequently in their investment decisions.⁴⁷ Other research found in 2017 that 31 per cent of investment firms provided ESG training to 'any employees' – up from 28 per cent in 2015. But the proportion that received formal training on how to consider ESG criteria in the investment decision process was much lower.⁴⁸

The evidence on the amount of assets actually allocated to SRI is not very encouraging

One estimate puts the value of global assets in funds managed with ESG criteria at \$360 billion.⁴⁹ This is a very large number. But there are three caveats. Firstly, total global assets under management are estimated to be worth just under \$85 trillion.⁵⁰ So, the \$360 billion represents just 1.2 per cent of total assets under management. Secondly, the same analysis estimated that ESG assets under management are growing at a rate of just under 5 per cent per annum compared to just over 7 per cent for overall assets under management. So, ESG growth appears to be lagging behind overall growth in assets under management. Thirdly, this figure includes the governance part of ESG, so the amount invested in our definition of SRI will be smaller still.

Large global institutional investors with assets under management of \$40 trillion actually increased their holdings in thermal coal by 20 per cent over the period 2016 to 2018.⁵¹

In 2015, the proportion of FTSE 100 companies in energy-intensive sectors was 30 per cent, by value.⁵² By March 2018, the proportion of the FTSE 100 accounted for by those groups of companies had actually risen to a combined share of around 36 per cent.⁵³

According to Carbon Tracker, the UK emits 1 per cent of global CO₂. But the market value of companies involved in fossil fuel activities listed on the UK financial markets means the City of London hosts companies responsible for 15 per cent of potential global CO₂ emissions.⁵⁴

Citizen/retail investor attitudes

Awareness of, and interest in, SRI amongst ordinary citizens and retail investors is increasing, but investing in SRI remains a minority interest

Data published by the Investment Association estimates funds under management in retail ethical funds to be £15.9 billion (see below).⁵⁵ At first glance, it suggests significant growth in ESG investments since the financial crisis – almost trebling in value terms. But, asset values generally have risen considerably over that period. ESG funds represent just 1.4 per cent of total assets under management. Even if the amount invested in ethical funds does continue to rise, it will be some time before it reaches the amounts invested in other assets, such as buy-to-let properties (see Annex).

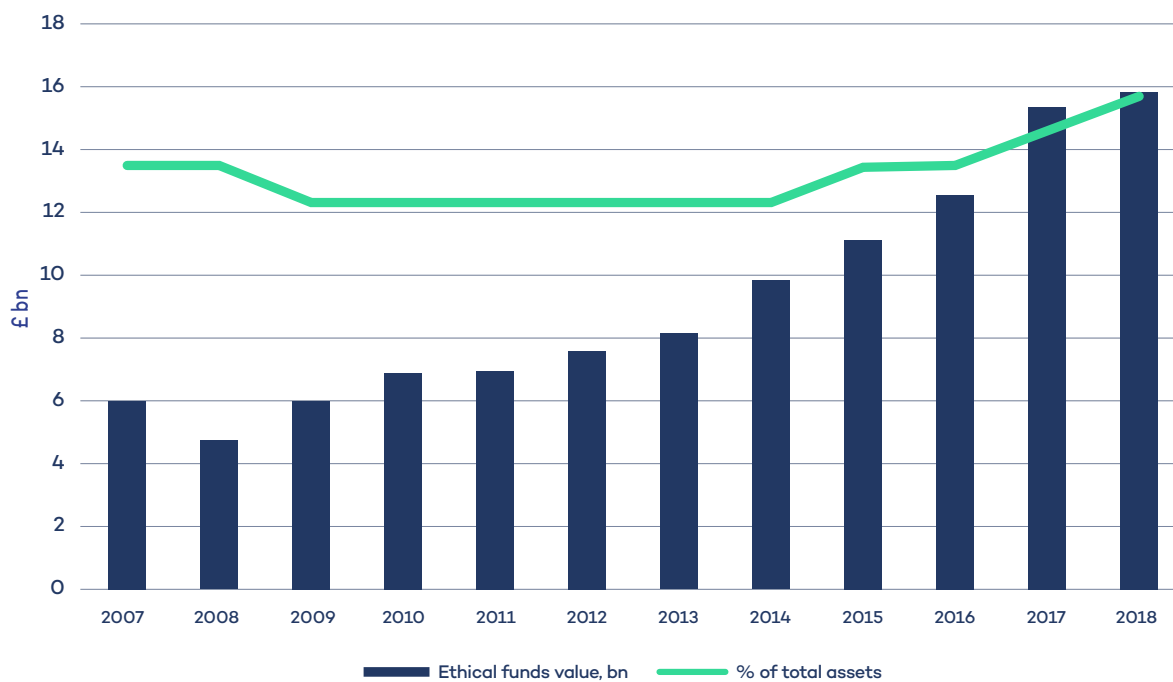


Figure 2: Ethical funds under management have grown, but remain a small share of retail assets under management. Source: Investment Association data

Company boards do not appear to be coming under particularly strong pressure from their shareholders (institutional or retail) to transform their businesses

Research conducted in 2018 found that just 40 per cent of listed companies in the benchmark UK FTSE 100 Index had assessed the climate change risks in their supply chain, compared to 57 per cent of companies in the US Dow Index, and 68 per cent in the Paris CAC index. Less than 20 per cent of FTSE100 companies had undertaken climate scenario analysis, compared to 30 per cent of their counterparts in the

Dow. Perhaps more concerning, only 28 per cent of FTSE100 companies had adopted climate mitigation practices – this compares to 63 per cent of companies in the Paris CAC index.⁵⁶

Looking at companies in the wider FTSE 350 Index, environmental issues were identified as a key risk by 73 per cent of energy, 54 per cent of industrial and 37 per cent of IT companies. But, just 29 per cent of companies in the energy sector, 20 per cent of industrial companies, and 21 per cent of IT companies included those risks as key performance Indicators (which influence organisational priorities and executive remuneration).⁵⁷

A recent analysis of over 250 of the world's highest emitting companies found that nearly half (46 per cent) of companies are failing to adequately integrate climate change into their business decisions. Only one in eight companies (12.5 per cent) are reducing carbon emissions at the rate required to keep global warming below 2 degrees. However, there are some signs of improvement.⁵⁸

The green bond market

The green bond market has grown at a significant rate, but it remains a small fraction of the vast total global bond market

The global green bond market (defined here as being 'climate aligned') was estimated to be worth \$1.45 trillion in 2018.⁵⁹ The size of the dedicated market for bonds labelled 'green bonds' (with finance earmarked for existing or new projects with identifiable environmental benefits) has grown at a fast rate. The amount outstanding rose by \$72 billion over the year and is estimated to be valued at \$389 billion, or 26 per cent of the total green bond market. But, to put that in context, total global green bonds represented just 1.45 per cent of the total global bond market valued at \$100 trillion.⁶⁰

Sixty per cent of the green bonds outstanding were issued by government entities of some sort – state-owned entities, local governments, multilateral development banks and other state agencies. Some of the largest single issuers are the China Railway Corporation (the largest issuer in the world), Network Rail, SNCF (the French national rail company), and New York Metropolitan Transportation Authority.

Globally, \$155.5 billion of green bonds were issued in 2017. This was just two per cent of the total bonds valued at \$6.7 trillion issued that year. In 2016 the world's top banks lent \$87 billion to projects related to fossil fuel extraction, while the oil and gas industry invested \$437 billion.⁶¹

Green bonds listed on the London Stock Exchange have raised in excess of \$20.2 billion in seven different currencies. There are now nearly sixty green bonds listed on the London Stock Exchange. Six renewable 'yield cos'⁶² have listed in London since 2013 with a total market capitalisation in excess of £2.2 billion. Thirty-eight green companies have raised a total of \$10 billion on the London markets, including 14 renewable investment funds. Even at the smaller end, there has been growing activity, with 121 UK energy projects raising €118 million in total across five energy crowd-funding platforms.⁶³

This is clearly progress. But the UK is one of the, if not the, leading financial centre in the world. There are high hopes that it might become the leading centre for green finance. However, evidence suggests that, when it comes to the domestic issuance of green bonds, the UK is actually lagging behind its major economic competitors. The Environmental Audit Committee reported that so far there has only been \$3.9 billion of domestic green bond issuance compared to \$41 billion in France and \$24.9 billion in Germany – both with much smaller financial sectors.⁶⁴ Indeed, looking at cumulative issuance of green bonds by countries, the UK does not even make it into the top 10.⁶⁵

The Organisation for Economic Co-operation and Development also surveys large insurers. In its latest analysis, it found that insurers in the EU/European Economic Area/Switzerland had 0.009 per cent of assets directly invested in green finance.⁶⁶ Sixty-six per cent of large global investors do not have any green bonds in their portfolios.⁶⁷

Direct investment in SRI projects

After promising growth, the amount of direct lending to SRI projects has fallen recently, and the UK is not meeting its investment targets

In 2008, a total of \$5.9 billion was invested in clean energy ventures, rising to \$25.9 billion in 2015. This fell to \$23.4 billion in 2016 and to \$10.3 billion in 2017.⁶⁸ Converting these figures into pounds sterling, the amount invested was equivalent to £3.7 billion in 2008, £17.4 billion in 2015, £19 billion in 2016 and £7.6 billion in 2017.

It was estimated in 2015 that the UK would need to invest £22 billion per annum to meet its carbon budgets.⁶⁹ In the past 10 years, the UK has never met that target – only in 2015 and 2016 did it come close.

The UK is falling behind its major international competitors in investment in clean technology (cleantech). Since 2013, global investment in cleantech has doubled but has declined in the UK. In 2012, over 160 cleantech deals worth over £700 million were done in the UK. In 2017, that had fallen to just over 60 deals valued at around £250 million.⁷⁰

Bank lending to SRI

Smaller, early stage SRI projects do not have good access to bond or equity markets and may have to rely significantly on bank lending – but bank lending to SRI remains a tiny fraction of total bank lending

Analysis published in 2018 estimated that the total value of green loans issued since the first transactions in early 2017 amounts to \$32 billion.⁷¹ It would appear that the total loans made in the UK amounts to \$1.625 billion (equivalent to around £1.24 billion⁷²) – this represents just over 5 per cent of the total amount listed in the analysis.

The actual figure may be much higher. We cannot say, because of the paucity of comprehensive analysis. But it does seem surprising that the UK share is so small, given the size of the UK banking sector. To put this in context, UK banks lent an average of £22 billion each month to non-financial corporations in 2017 and 2018.⁷³ Banks lent £725 billion in 2017 to micro and small businesses.⁷⁴

The Bank of England

QE has affected the allocation of resources in the real economy

Analysis of the impact of the Bank of England's programme to purchase corporate bonds (the mechanism by which QE works) found that this was actually skewed towards high-carbon sectors.⁷⁵ For example, the manufacturing and electricity production sectors comprise 49.2 per cent of the bonds eligible for purchase (in the Bank of England's eligible benchmark). This sector makes up just 11.8 per cent of the UK's gross value added (GVA) but is responsible for 52 per cent of emissions in the UK.⁷⁶ To be fair, the availability of green bonds is limited. Nevertheless, there is no question that the Bank's decisions have been skewed towards climate negative industries.

Data on economic activity and jobs

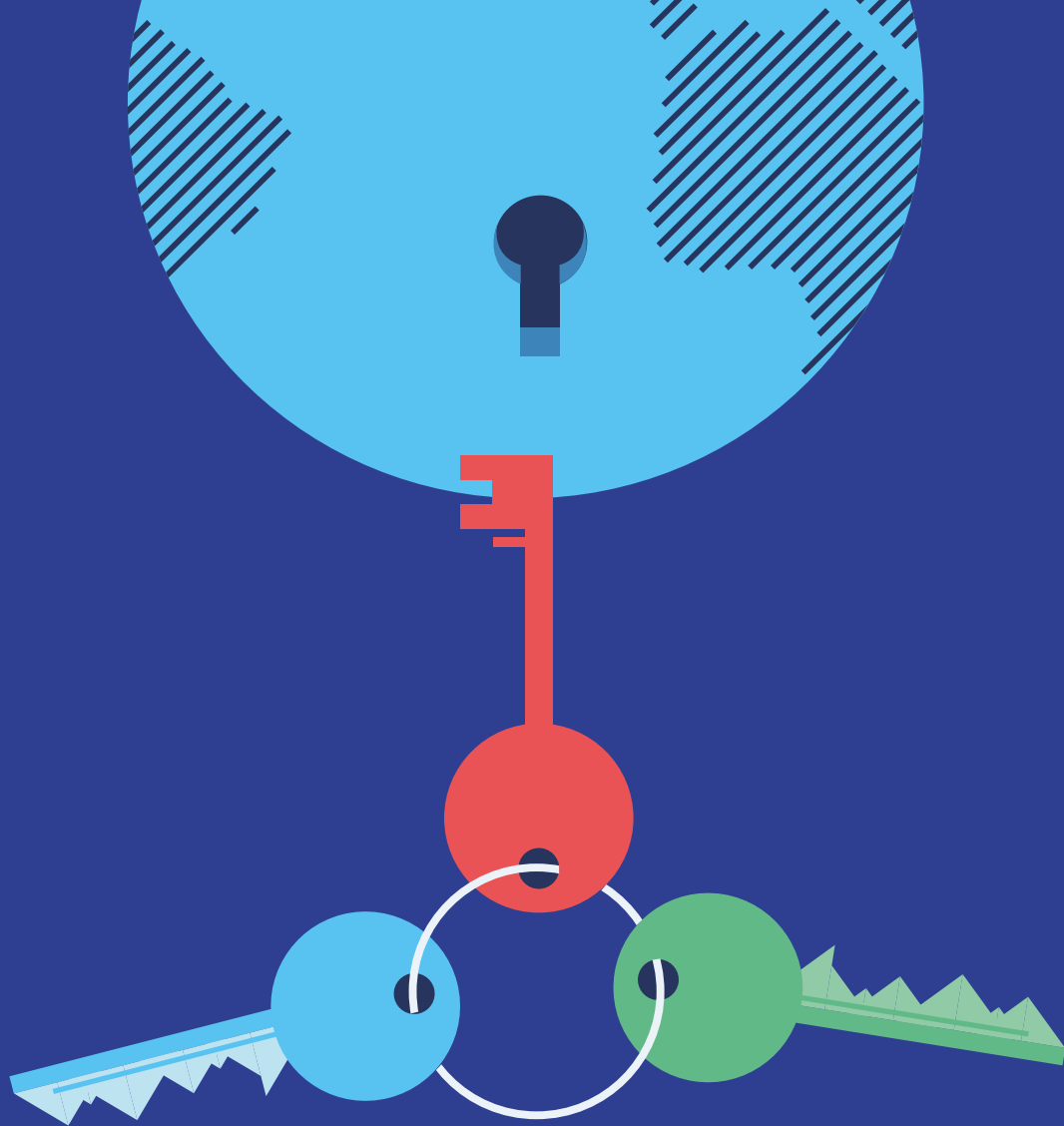
Economy activity in the low carbon and renewable energy sectors has been disappointing

Ultimately, to be effective, SRI financing needs to feed through into greater activity in SRI sectors of the real economy. The number of businesses in the low-carbon and renewable energy sectors fell by 16 per cent from 105,500 in 2015 to 88,500 in 2018. Turnover rose by £4 billion in real terms over the same period, from £43 billion (adjusted for inflation) in 2015 to £47 billion in 2018. Employment in the sector rose from 200,800 to 224,800. But, despite the rises, the sector accounted for just one per cent of total non-financial turnover and employment in 2018, similar to 2015 and 2017.

Table 1: Economic activity and jobs

| Year | No. of businesses | Employment FTE | Turnover £billion |
|------|-------------------|----------------|-------------------|
| 2014 | 93,500 | 235,900 | 43.7 |
| 2015 | 105,500 | 200,800 | 40.4 |
| 2016 | 84,500 | 211,000 | 41.1 |
| 2017 | 83,000 | 219,900 | 44.6 |
| 2018 | 88,500 | 224,800 | 46.7 |

Source: ONS, Low carbon and renewable energy economy survey direct estimates, UK, 2014 to 2018, <https://www.ons.gov.uk/economy/environmentalaccounts/bulletins/finalestimates/latest>



Section 2

The factors that constrain growth in SRI finance

The prize for channelling even a small fraction of available assets into SRI is considerable. The question we now turn to is: why has progress been so limited, and what are the factors that limit the greater financing of SRI?

There are daunting barriers to overcome to promote greater financing of SRI. We categorise these into: factors specific to SRI; institutional factors; the impact of legislation and regulation; information and perception factors; the culture of short-termism; and other market factors.

The payback periods and up-front costs associated with SRI can make the assets unattractive to financial markets where short-termism is still dominant

New SRI projects can have long payback periods (7–12 years), which means that financial institutions providing direct finance can wait a long time (comparatively speaking) to see a return on their investment. Part of this relates to the high up-front capital costs required to set up certain green projects. In the energy sector, one estimate puts these costs at 84–93 per cent of total project costs for wind, solar, and hydro energy compared to 66–69 per cent for coal and 24–37 per cent for gas.⁷⁷

With established companies listed on stock markets, transforming activities to become SRI compliant can take some time and investment. This can deter boards and executives of firms who feel they must satisfy financial markets in which short-term thinking dominates (see below).

The ability to easily exit investments or sell on loans can be important but may not be available with certain types of SRI

The ability to exit an investment (if prospects change) is an important consideration for investors. This is not generally an issue with mainstream assets such as equities and bonds that are traded on public markets. If an investor wants to sell, there will be a buyer willing to purchase bonds or shares – in all but the most extreme circumstances. Similarly, lenders may want to sell on loans to meet changing risk profiles. Linked to this is the issue of liquidity. Investors and lenders may need access to cash at short notice (see below).

In contrast, the same market infrastructure to provide willing buyers and sellers and liquidity is not yet in place for SRI assets. This makes SRI more risky in the eyes of financial institutions – more so when combined with the long payback periods mentioned above.

Institutional factors

The nature and duration of the liabilities that investors and banks have to manage influence funding decisions

Defined benefit (final salary) pension schemes provide a good example of the constraints faced by financial institutions. They need to model how much money they will need in future to meet pension promises (the liabilities), how much they need to pay into a scheme, and what investment returns they need to generate to have sufficient funds in future. This can drive them towards less risky, less volatile asset classes so they can model the range of potential investment returns with more certainty.

There is the argument that the long-term nature of pension fund investments means that they should be able to take risks to meet those liabilities. But, in reality, structural changes to the defined benefit pension sector (still the largest type by value) means the point at which liabilities crystallise is getting nearer. The ability to tolerate uncertain investment returns over a long period of time is limited.

Similarly, life insurance firms that provide annuities (which offer the promise of a predictable retirement income) have to maintain a high proportion of less risky assets to cover annuities in payment. General insurers also need to maintain a high proportion of less risky assets to meet immediate claims on insurance such as car or home contents insurance.

Defined contribution and personal pension schemes should, in theory, be better placed to take a long-term approach. The risk here is transferred to the employee or individual. But, as we explain elsewhere, there are cultural and behavioural constraints that limit the use of SRI as a vehicle for long-term investing.

Banks are an interesting example. Banks famously ‘borrow short, lend long’. That is, they borrow in the form of taking deposits (usually repayable on demand or with short notice) from consumers and businesses and lend out in the form of mortgages (which are often very long-term). So, in theory, they should be willing to lend to long-term projects. But, banks are very familiar with the risks associated with mortgages and can diversify this risk. Banks also make commercial loans, which are typically between 3–5 years whereas, as explained elsewhere, the payback periods for early stage SRI projects could be between 7–12 years. With the nascent SRI sector, the same mechanisms for diversifying risk and comprehensive risk data are just not available.

Tolerance to risk influences the choice of where financial institutions allocate financial resources

A fundamental principle of financial market behaviour is that lenders or investors will expect a higher return to compensate if they are expected to take on a higher risk. Risk can take a number of forms, including the risk of losing money, market volatility, uncertainty of returns, illiquidity and absence of good performance data and risk information on which to base financial decisions.

As well as long payback periods and high up-front costs, SRI remains comparatively unknown compared to more traditional asset classes, which are covered by an industry of analysts, research agencies and information providers.

SRI ventures do not have the same track record as traditional investments, so it can be difficult to incorporate these alternatives into the risk models that provide the foundation for strategic long-term and medium-term asset allocation decisions.

Financial institutions may need to maintain a proportion of funds in accessible, liquid assets, constraining their ability to fund long-term projects

For example, defined benefit pension schemes with a large number of members already in retirement will need to retain a large proportion of liquid assets to pay out pensions. Fifty-six per cent of defined benefit schemes currently have negative cash flow (more money is going out than coming in), and of the rest, 83 per cent are expected to within 10 years.⁷⁸

The impact of legislation and regulation

Poorly designed financial regulation, or misconceptions about the law and regulation, can influence decisions to fund SRI

Prudential regulation requires banks, funds, schemes and insurance companies to quantify their liabilities, identify future risks and hold a proportion of funds in ‘safe’ assets to protect against the risk of default or not being able to meet their liabilities.

Prudential regulators also attribute different risk weightings to different types of financial activity. So, the amount of capital financial institutions must hold in reserve against the risk of default varies depending on the type of financial activity they are engaged in. Holding capital against the risk of loss and/or default has the effect of reducing profits, which means that banks can be more reluctant to lend to activities considered risky.

For this reason, the European Commission has been considering introducing a ‘green supporting factor’. This would have the effect of reducing the amount of capital banks have to hold when making loans to activities that support the transition to a sustainable economy.⁷⁹

Campaigners take the view that this would do little to divert significant lending to green activities away from 'brown' activities⁸⁰ and could just encourage 'greenwashing', where banks try to classify brown industrial activities as green in order to take advantage of the green supporting factor. They argue that it would be better to introduce a 'brown penalising factor', which would deter lending to environmentally risky activities.⁸¹

The issue of fiduciary duty has been at the centre of the debate about the role of pension schemes in SRI. Trustees have expressed concerns that investing in SRI may be at odds with their fiduciary duty to maximise returns for scheme beneficiaries. But, the Government has recently clarified that 'financially material considerations include (but are not limited to) environmental, social and governance considerations (including but not limited to climate change), which the trustees of the trust scheme consider financially material'.⁸²

But there is clearly a job to be done to educate and reassure pension fund trustees – including that far from damaging the interests of scheme members, not investing in SRI may be against scheme member interests.

As SRI has risen up the agenda, less sophisticated depositors and investors are becoming more vulnerable to the risk of greenwashing or outright mis-selling of green financial products. During the course of the research, we found examples of 'green' bonds offering returns of 9 per cent per annum, even as high as 18 per cent per annum. It is likely that we will see a tightening of conduct of business⁸³ regulation and consumer protection regulation in relation to SRI. This will be welcome if it protects consumers and promotes greater confidence and trust in SRI. But if any new regulations or rules are not sensitively calibrated, this could make it more difficult to promote smaller, early stage SRI ventures.

Information and perception factors

While attitudes towards SRI are increasingly positive, there are concerns about the availability of good data, research and analysis, and the financial returns available from SRI

A major factor cited by financial institutions is the lack of:

- good data on risk and potential returns available from SRI;
- clear definitions and criteria for determining whether an economic activity is sustainable or socially positive; and
- consistent disclosure and trustworthy benchmarks to allow lenders or investors to evaluate how compliant loans or investments (and portfolios of loans/investments) are with SRI objectives.

Larger established infrastructure projects have fairly predictable returns and are analysed in depth by analysts and credit ratings agencies. Similarly, for companies listed on stock markets, comprehensive historical financial data and benchmarks are available to allow investors and analysts to model potential risk and return before asset allocation decisions are made. Credit ratings agencies are governed by an established legislative and regulatory framework.⁸⁴

In contrast, there is limited availability of research and risk data (at the individual project level and as an asset class) on SRI ventures – particularly smaller or early stage SRI ventures. This lack of data means that investors/analysts/advisers would have to devote more time and resources to identify potential opportunities and undertake due diligence to understand the risks involved. Hidden value may be difficult to spot. The additional search costs and due diligence involved combined with the intrinsic high risk of early stage SRI projects and long payback periods can make SRI unattractive to risk-averse institutional investors (see above).

This is supported by research. Seventy-nine per cent of global institutional investors surveyed identified barriers to increasing the level of climate friendly investment in their portfolios. Lack of credible investment opportunities (see below) is cited as the main barrier, along with poor availability of research and analysis and lack of standardised sector definitions. Eighty-four per cent thought there were barriers to greater social impact investment, citing lack of credit opportunities, the regulatory framework and poor availability of research and analysis as the key factors.⁸⁵

Recent research found that the top three barriers to greater investment by European pension funds in green sustainable investment were: concerns about investment performance (53 per cent in 2018, up from 47 per cent in 2017); lack of transparency and reported data (50 per cent in 2018, up from 44 per cent in 2017); and difficulty measuring risk (33 per cent in 2018 compared to 26 per cent in 2017).⁸⁶

In another survey, 56 per cent of global investors (76 per cent of investors in Europe) said that current standards of disclosure by companies on levels of carbon were 'highly inadequate'.⁸⁷

When asked what would help them invest in more sustainable investments, the top three answers given by European pension funds were: evidence that shows investing sustainably delivers better returns (30 per cent); greater transparency by companies on both financial and non-financial performance reporting (27 per cent); and better ESG-related benchmarks (14 per cent).⁸⁸

In 2019 the European Commission's Technical Expert Group published its report on an EU sustainable finance taxonomy.⁸⁹ The intention is that this will be incorporated into legislation. This could provide a consistent framework for assessing SRI activities. But it could be some time before this taxonomy is incorporated into legislation at EU and UK level (if ever in the UK, due to Brexit). Moreover, it is not yet clear if this new taxonomy on its own will be enough to change the behaviours of lenders and investors without other interventions.

Contrary to perceptions, investing for good need not be at the expense of decent financial returns

Previous research has found green investments were considered a low-return/high-cost option, while ethical considerations were not seen as being front-of-mind when making decisions.⁹⁰ But there is compelling evidence of a strong business case for ESG investment.⁹¹ Other research found that large firms with high ESG ratings produced higher returns on capital invested over the five years to the end of 2017 than those with lower ratings. This research found that the environment and social impact factors of ESG were more important than the governance factor.⁹² But other research suggests that the governance factor is slightly more important, although environmental and social factors were still found to have a positive impact.⁹³ However, that data is either not well known or accepted by enough investors and their advisers.

Promoters of SRI face a 'Catch 22' problem when developing an infrastructure to support the growth in SRI assets

Mainstream financial assets are supported by a well-established market infrastructure. For example, in addition to comprehensive risk data and research, there is a well-established primary and secondary market infrastructure to allow listed companies to raise capital and enable subsequent trading and asset management of shares.

For smaller companies, there are specialist fund managers that have identified potential investment opportunities and packaged these together in collective investment funds (such as unit trusts or investment trusts). This diversifies risk and reduces the cost of investing in the small company sector by creating economies of scale.

In contrast, for the SRI sector, in addition to the limited data and research described above, there is a limited primary and secondary market infrastructure to enable capital raising and secondary trading of assets.

Furthermore, there is a lack of collective investment vehicles that enable financial institutions to fund smaller SRI ventures in a cost-effective way and to diversify risk.

But, the level of resources needed to develop the necessary information and research resources, collective financial vehicles and supporting infrastructure is unlikely to result unless and until SRI asset classes become more popular. However, investors are unlikely to invest more in SRI assets without that necessary research and infrastructure – a Catch 22 situation. This is a particular problem for the smaller SRI ventures. It is not clear that the market can or wants to address this – other stakeholders may need to take the lead in developing the solutions.

The culture of short-termism

The dominant culture in financial markets remains short-termist

By its nature, SRI requires a longer-term approach to financing. But research suggests that fund managers tend to hold stocks for 1–3 years.⁹⁴ Stock market turnover (how often fund managers buy and sell shares) is on a long-term upward trend (see Annex).

Transforming the UK economy means spending resources on R&D and greater long-term investment; but the UK scores poorly on those factors, influenced in part by the short-term culture prevalent in financial markets

Greening the UK economy will require significant investment in R&D. We do not have data on the amount spent specifically on climate-related R&D. But we can get an idea of the attitudes to R&D in the UK from wider economic data. The UK has one of the lowest levels of spending on R&D (as a percentage of GDP) of the major G7 countries (see Annex for data on R&D).

Similar, looking at corporate investment more generally, we see the UK has a significantly lower rate of investment than its EU counterparts. Non-financial corporations in the EU 28 countries invested nearly 23 per cent of GDP on average over the period covered. UK firms invested under 18 per cent on average over the same period – the gap has averaged 5 per cent each year (see Figure 3).

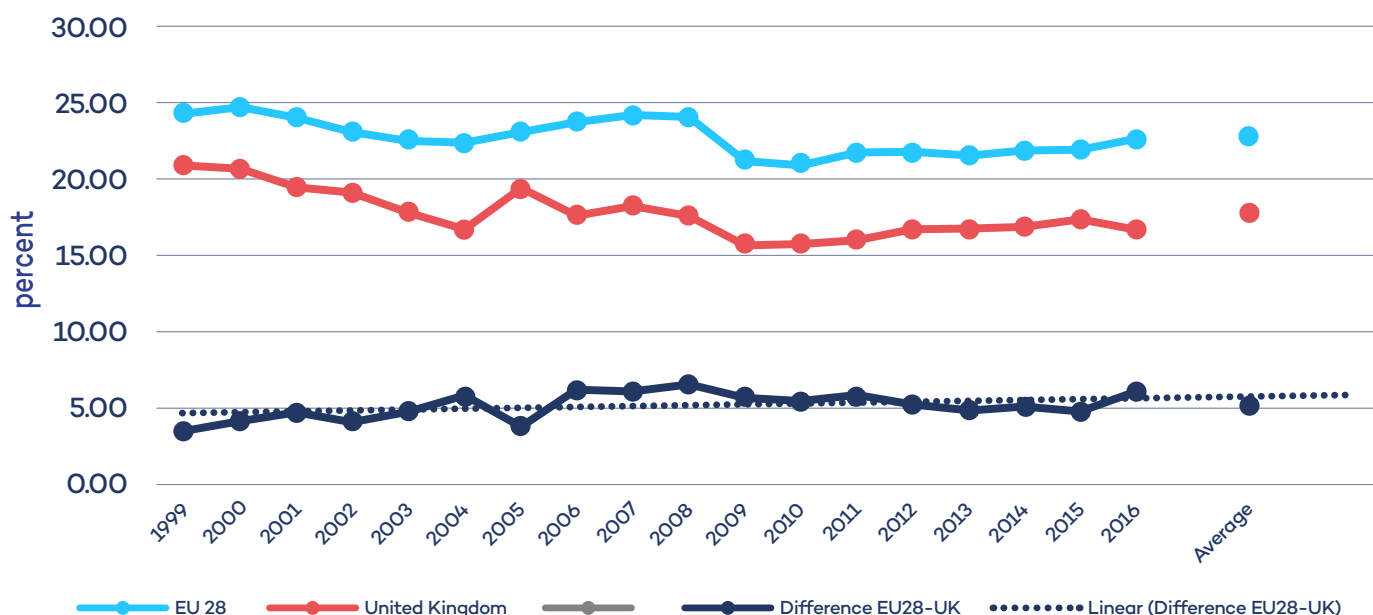


Figure 3: Investment rate of non-financial corporations

Source: Eurostat NFC Annual Indicators, <http://ec.europa.eu/eurostat/web/sector-accounts/data/annual-data>. Calculated in per cent as: gross fixed capital formation/gross value added of non-financial corporations

The dominance of shareholder value itself may act as a barrier to greater SRI

Transforming the economy requires higher levels of financing of R&D and innovation. But the pressure to generate short-term returns for shareholders affects the ability of real economy firms to raise money or use profits to invest for the long term. Share buybacks by listed companies have consistently exceeded the issuance of shares over the past decade.⁹⁵ Total pay-outs (in the form of share buybacks and dividends) fell sharply after the global financial crisis but have since recovered and actually passed their pre-crisis peak in 2014 (these subsequently fell again, but the post-crisis trend is upwards).⁹⁶ The equity market no longer appears to have been a source of net new financing to the UK corporate sector.

The Trades Union Congress (TUC) concluded in its work on corporate governance that the pursuit of shareholder value leads to lower levels of investment and undermines innovation.⁹⁷

All in all, it would seem reasonable to conclude that the short-termism prevalent in our financial markets is not very conducive to the long-term approach needed to transform the economy to meet SRI criteria.

Banks still prefer to lend to other parts of the financial system, the property sector and mortgages and credit, rather than to the real economy

As covered in the Annex, the evidence suggests that banks still tend to prefer to lend to other parts of the financial system, to the property sector or for mortgages and consumer credit, rather than to real economy firms. The amount of bank direct lending to SRI ventures remains very low. Banks may take some persuading to lend significant amounts of SRI.

There is a limited supply of quality SRI financing opportunities

Comments made by experts during the interviews backed up survey data citing lack of availability of credible opportunities to finance SRI as being a key barrier (see above). The concern expressed to us was that higher-quality SRI ventures command a premium (that is, they are already overpriced), which means that the potential for good future returns may be limited. In other words, there is too much money chasing too few good-quality projects.

Clearly, if the right mechanisms can be developed, there is the potential to channel significant resources from the financial system into SRI activities in the real economy. But, if there are insufficient SRI opportunities to finance, much of this potential could be wasted.

Other market factors

The growth in passive investment funds may direct resources away from SRI

According to the Financial Conduct Authority (FCA), the value of assets managed passively has grown from £59 billion in 2012 to £165 billion in 2017 and now constitute 25 per cent of total assets under management in the UK.⁹⁸

Passive fund managers use techniques to match, rather than beat, the performance of a benchmark index such as the FTSE All Share Index. This means they will not be interested in investing in new SRI ventures that fall outside the main markets. It also means that if a company from one of the energy-intensive sectors enters their chosen benchmark index, they may be required to buy shares in that company if they want to match the performance of that index. However, there are now some indices that exclude shares which do not meet SRI criteria and can be tracked in a similar way to mainstream passively managed funds.

Investment consultants and advisers are key gatekeepers on investment decisions

Civil society organisations such as ShareAction do an impressive job engaging with pension scheme members and financial institutions on climate change and corporate responsibility. But it is difficult to envisage a sea change happening without the involvement of influential intermediaries such as investment consultants and financial advisers.

Pension funds (employers and trustees) defer to these influential investment consultants on investment strategies, how to manage risk, and how to diversify investments and manage liabilities. They are unlikely to risk significantly increasing their exposure to SRI, still considered to be novel investments, without direction from consultants.

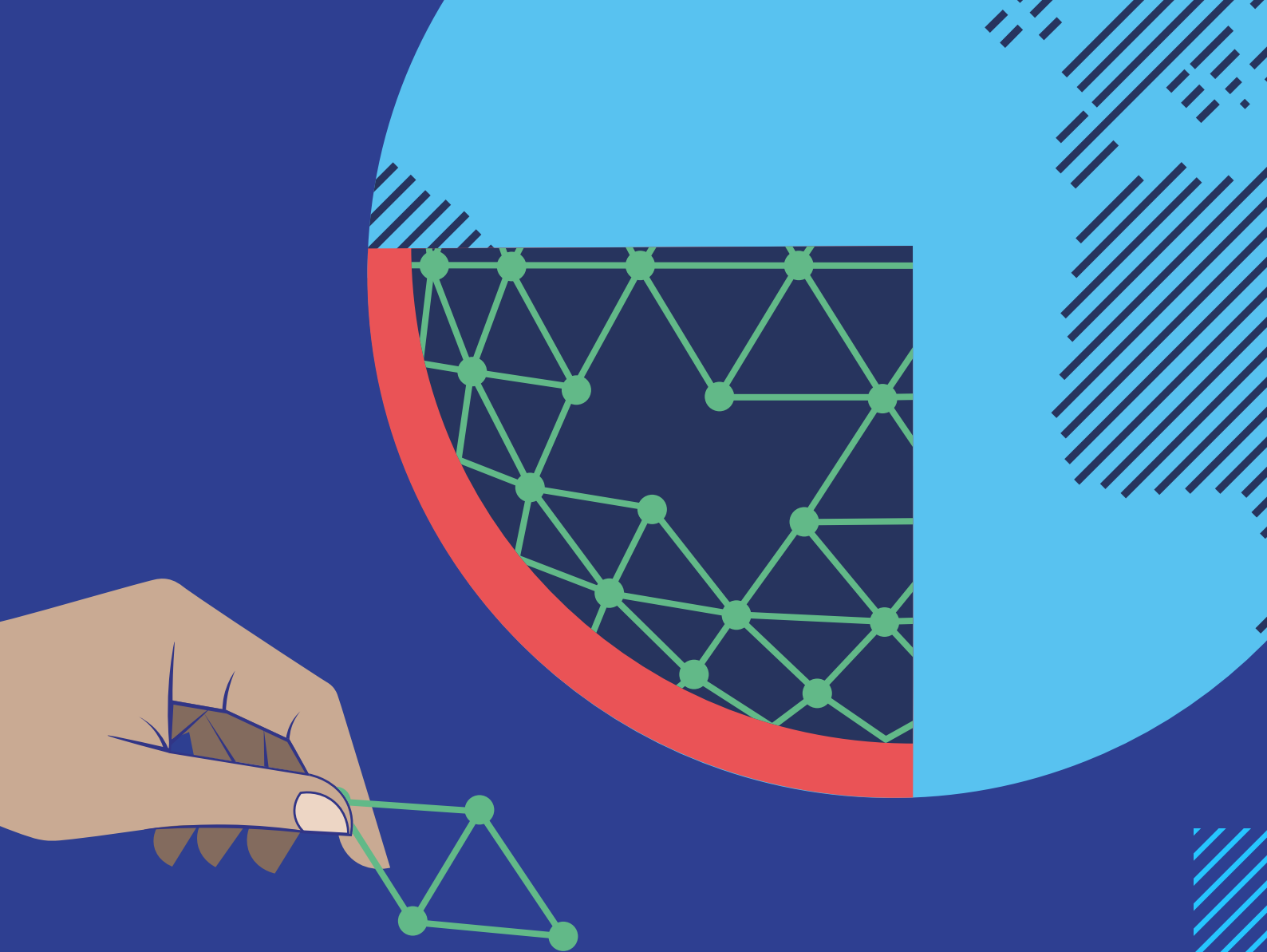
According to the Competition and Markets Authority, investment consultants influence investment and asset allocation decisions made by pension schemes with £1.6 trillion of assets⁹⁹ – note the total size of pensions assets is estimated to be in the region of £2.4 trillion (see page 00).

Three-quarters (73 per cent) of pension schemes are currently buying investment consultancy services from investment consultants. Over nine in ten (94 per cent) large pension schemes use investment consultancy services, as do just under nine in ten medium schemes (87 per cent).¹⁰⁰

Similarly, the bulk of investment decisions made by retail investors are influenced by financial advisers and investment managers. According to the FCA, £926 billion of assets are held or managed in the wealth management sector; £736 billion (79 per cent) is managed by wealth managers, and £190 billion (21 per cent) was invested on an execution only basis.¹⁰¹ We do see signs of a shift in attitudes of advisers towards green finance and social impact investment.



But, as with investment consultants, more needs to be done to persuade financial advisers of the merits of SRI, and to improve the quality of data on risk and reward to provide reassurance.



Section 3

Policy interventions to support greater SRI financing

There is no doubt that environmental factors and the social dimension (such as fair treatment of the workforce and human rights abuses) have come to the fore in financial markets. The signs that this growth will continue are positive. But there is clearly more to do – especially when it comes to encouraging the much-needed direct investment in new green finance and social impact initiatives.

There is a range of existing information programmes and market-led initiatives designed to promote greater use of SRI. These are important, but we do not think these go far enough to change minds and behaviours, and to mainstream SRI into financial markets. We make 41 specific policy recommendations, grouped around core policy objectives.

Theory of change

The objectives of the policy recommendations are to:

- raise awareness of SRI as an issue;
- improve the amount and quality of information, research, and analysis available on SRI;
- enhance the knowledge and skills of stakeholders involved in SRI
- improve and maintain confidence and trust in SRI assets;
- change minds and behaviours by encouraging investors and lenders (public and private) to become more engaged with SRI, and ensure SRI is embedded into decisions made by lenders, investors, and influential intermediaries;
- better align behaviours in financial markets with SRI goals;
- improve the market infrastructure available to support greater levels of SRI financing;
- create a more supportive regulatory architecture and regulatory objectives; and
- increase the supply of viable SRI financing opportunities.

Ultimately, the overarching goal of these policy recommendations is to increase the share of resources allocated to SRI by the public and private sector.

Policy objective 1: Raising awareness of SRI

Although there has been real progress on this front, there is still much to do to raise awareness of the importance of SRI and make the connection between decisions made in financial markets and the impact on the environment, real economy and wider society. Moreover, there are still misconceptions about the risks and returns associated with SRI.

Recommendation 1: Government, civil society and other stakeholder groups should develop a sustained initiative to raise public awareness of:

- how the lending and investment decisions made by or on behalf of ordinary citizens can have an impact on the environment and social goals – ‘how your money can be a force for good and for bad’;
- what rights investors have, and how much say they have, about how their money is being used;
- the practical actions citizens can take to put their principles into practice; and
- the risks and rewards associated with SRI.

In other words, a campaign is needed to better inform citizens and give them choice and voice in the financial system.

Recommendation 2: To support the public awareness initiative, stakeholders should undertake robust research to identify:

- to what degree citizens/investors make a connection between decisions made in the financial system on their behalf and the impact on the environment, and social issues;
- to what degree they believe they can influence financial decisions;
- how willing investors are to use their voice in the financial system; and
- to what degree they understand risks and rewards associated with SRI.

Policy objective 2: Improving the amount and quality of information, research and analysis available on SRI

There are some very good data sources on the sustainability performance of individual companies.¹⁰² But information, research and analysis on SRI issues remain fragmented and underdeveloped, and relatively inaccessible compared to that available on mainstream financial assets. There is still a significant information asymmetry problem.

Recommendation 3: Stakeholders should collaborate on developing and promoting a central repository of information, research and analysis on SRI. This should be accessible to financial institutions, regulators and citizen-investors. This repository should:

- include guidance and educational material on SRI;
- maintain a directory of financing opportunities to help match potential funders/investors with those needing capital;
- include a database of research and data on the risks and returns associated with SRI;
- provide guidance on how to understand and manage risks intrinsic to SRI – including how to model SRI related risks and rewards in the absence of historical data, and the use of appropriate benchmarks to assess risk/ returns; and
- provide alerts to lenders, investors and regulators on potentially misleading risky financial products and funds badged with SRI.

Recommendation 4: Stakeholders should collaborate on developing and maintaining a UK SRI classification system (taxonomy) to make it easier for lenders and investors (institutional and retail) to identify the degree to which economic activities, sectors of the economy and individual firms in the real economy contribute to SRI goals. This should build on and align with the proposed new EU taxonomy for sustainable investment.

Recommendation 5: Based on the taxonomy above, stakeholders should evaluate and rate the degree to which individual companies (above a certain size) and different sectors of the economy comply with SRI goals. These SRI ratings should be published on a central database. Stakeholders should develop SRI indices that map onto mainstream market indices.

Recommendation 6: New metrics are needed to address the risk of greenwashing and allow lenders, investors and consumers to match their financial commitment to their SRI preferences. Stakeholders should develop and promote a new standardised SRI compliance rating system.

Individual SRI risk ratings (see above) could be combined to measure the overall SRI risk for loan and

investment portfolios/vehicles, indices, pension funds, insurance companies and financial products.

There are a number of approaches that could be adapted from mainstream financial markets. For example, credit rating agencies rate the bonds of individual corporations and bond portfolios, while investment analysts rate individual shares and provide overall risk ratings for investment funds such as unit trusts. This would help lenders and investors to tailor their financial decisions to their SRI risk tolerance – that is, some will want ‘pure’ SRI, others will prefer a blended approach with SRI and non-SRI within their portfolios. For this to happen requires a trusted, robust and consistent SRI risk rating system.

Recommendation 7: For retail investors, we recommend the creation of a single, easy-to-understand SRI rating label that can be used alongside clear financial risk warnings. Eventually, these ratings could be incorporated into comparative information websites.

Policy objective 3: Enhancing the knowledge and skills of stakeholders involved in SRI

Huge efforts have been made to tackle information asymmetries in retail financial services by providing consumers with comparative information on financial products and services, topic guides, and so on. This has been accompanied by concerted, dedicated programmes to raise levels of financial literacy and capability in schools, the workplace, and through agencies such as the Money and Pensions Service and various financial education charities.

There is also a large body of academic and policy research into the levels of general financial literacy and financial capability amongst financial consumers.

In contrast, there is limited research available into trustee/investor/citizen knowledge and skills in the SRI field.

Recommendation 8: Stakeholders should develop a programme to enhance SRI literacy and capability, and establish a centralised resource for educational material on SRI issues. To ensure that SRI literacy and capability programmes are effective, stakeholders should also undertake a research programme to understand in more detail the level of understanding of SRI issues, and where the major gaps are.

Recommendation 9: The objectives of the Money and Pensions Service should be amended to promote awareness and improve consumers’ knowledge of SRI issues.

Policy objective 4: Improving and maintaining levels of confidence and trust in the SRI sector

There appear to be four main factors that could undermine the goal of promoting confidence and trust in SRI:

- the lack of good information and advice on SRI as an asset class, which means it is still a comparatively unknown quantity;
- the risk of greenwashing;
- the perception (mistaken) that SRI assets produce lower returns than mainstream assets – that there is a price to pay for acting responsibly; and
- the risk of consumers being mis-sold financial products and investments badged as SRI – if we see a major mis-selling scandal involving SRI this could set back the sector.

The measures outlined above would go some way to addressing the information gaps and the risk of greenwashing, and communicate the evidence on risk and returns available from SRI. But additional work is needed here.

Recommendation 10: As part of the research programme suggested in Recommendation 9, stakeholders should research in more detail the factors that undermine confidence and trust in SRI, and what steps could be taken to improve levels of confidence and trust.

Recommendation 11: SRI investment funds and financial products (and the providers and intermediaries who promote and distribute these funds/products) should be subject to the same FCA regulatory regime as mainstream financial products, and be covered by the Financial Ombudsman Service and the Financial Services Compensation Scheme. Anyone promoting or distributing a regulated SRI fund/product without FCA authorisation should be subject to the full range of legal enforcement and sanctions.

Greenwashing and, more generally, misleading promotions of SRI should be made a breach of FCA regulations.

Recommendation 12: The FCA should also step up warnings to potential investors about the risks of investing in funds and providers that are not subject to full regulatory protections.

Policy objective 5: Changing minds and behaviours

Awareness of and potential demand for SRI needs to be translated into action if it is to make a difference to the real economy. As it stands, financial institutions and investors appear to show limited propensity to allocate significant resources to SRI, and still tend to default to mainstream assets.

Government has clarified pension scheme trustees' fiduciary duty with regards to consideration of 'material risks' relating to ESG. This should help embed environmental factors in the investment decision-making process.

But, disappointingly, this will not apply to social impact investing. Moreover, pension scheme trustees do not have to formally consult scheme members on SRI issues or act on their views.

In other words, better disclosure and information is necessary, but not sufficient. Financial markets need to be steered or even compelled to act.

Recommendation 13: Pension fund trustees' fiduciary duty has been clarified with regards ESG factors. Government should also ensure that this includes consideration of social impact investments.

Recommendation 14: Government should require pension fund trustees to formally engage and consult with scheme beneficiaries on how SRI issues are factored into pension scheme investment strategies. Trustees should be required to explain and justify any decision that was contrary to the views of scheme beneficiaries.

Recommendation 15: For contract-based pension schemes, the FCA should require Independent Governance Committees to:

- oversee how scheme managers incorporate SRI factors in the investment decision process;
- report publicly to members on the scheme managers' policies on SRI;
- take on board scheme members' SRI views, and report publicly how the scheme manager has responded to these views.

Recommendation 16: Financial institutions (banks, asset managers, pension funds, insurance companies) should be mandated by regulators to assess how lending and investment decisions contribute to or detract from SRI goals.

Recommendation 17: Enhanced regulation and guidance should be introduced for financial institutions and intermediaries on how the results of the above assessment are communicated to stakeholders (trust based and contract based pension scheme members, insurance company policyholders, depositors, shareholders and bondholders).

These new duties should be overseen by the FCA, PRA and TPR. Appropriate sanctions for breaching regulations on factoring in SRI and communicating decisions should be introduced.

In keeping with The Pensions Regulator guidance to trust-based pension schemes, the FCA should issue clear rules for contract-based pension schemes on how to incorporate SRI factors when disclosing information and reporting to scheme members.

Recommendation 18: Campaigners should focus efforts on better understanding the attitudes, behaviours and decision-making processes of pension fund and investment consultants and target them with campaigns to embed SRI into decision-making.

Policy objective 6: Aligning interests and incentives in the financial system

If real change is to happen, the interests of influential decision-makers in financial markets (banks, insurers, pension schemes, fund managers, investment consultants, financial intermediaries and advisers), real economy firms and SRI goals need to be better aligned. Short-termism remains a particular problem.

Recommendation 19: Stakeholders should develop and promote a new SRI toolkit to give pension fund trustees, other asset owners and intermediaries (investment consultants and financial advisers) the confidence to incorporate SRI into investment strategies. This toolkit should include advice and guidance on how to:

- move away from measuring the quarterly performance of fund managers to longer-term performance analysis and reporting, including the use of alternative benchmarks;
- incorporate SRI into investment strategies, and use SRI to match long-term liabilities; and
- incentivise and encourage investment SRI-positive behaviours by fund managers and, where performance fees are used, align these to SRI goals.

Recommendation 20: Stakeholders should improve efforts to educate pension fund trustees, other asset owners and institutional investors on how to exercise effective stewardship over companies they invest in. This should include advice and guidance on how to challenge:

- executive remuneration that incentivises and rewards short-term corporate performance; and
- organisational behaviours in company supply chains that do not comply with SRI criteria.

Recommendation 21: Government should mandate reporting by publicly listed companies, large private companies, asset owners and asset managers on the degree to which their activities contribute to or detract from SRI goals. Government should set a deadline for compliance.

Recommendation 22: Government should consider new tax structures to encourage long-term investing and deter short-term speculation. Priority should be given to a Financial Transactions Tax.¹⁰³ To encourage early stage SRI, consideration should be given to introducing new tax-advantaged SRI venture capital schemes.

Recommendation 22: Government should consider new tax structures to:

- deter executive remuneration schemes based on short-term corporate performance; and
- encourage long-term investment in R&D with a focus on climate-related projects and cleantech.

Recommendation 23: ‘Green supporting’ factors being developed by the EU to encourage sustainable finance runs the risk of banks misleadingly badging loans to reduce risk weights and capital held. There are also concerns that supporting factors would need to be very large to have any real impact.¹⁰⁴ This could have the effect of allowing banks to increase their leverage.

There should not be a conflict between two equally important public policy objectives – promoting safer financial institutions and financial stability, and promoting greater SRI financing. Instead, policymakers and regulators should consider deterrence factors for ‘brown assets’ such as fossil fuel activities. This could make green finance more attractive without compromising on financial stability and prudential regulation.

Policy objective 7: Developing the right market infrastructure to support SRI

If we want to support the necessary growth in SRI finance, an appropriate market infrastructure needs to be developed. This includes: comprehensive research and risk data, secondary markets to exit investments and provide liquidity, cost-effective vehicles for diversifying the risk of investing in SRI and new public and private mechanisms for channelling resources into SRI ventures.

Private sector funders appear very reluctant to finance early stage or higher risk projects. Some argue that state support is needed – for example, government taking on or subsidising the risk of early stage projects and then, once established, transferring to the market for further funding. But this creates its own set of problems, as the state (i.e. the taxpayer) would take on the risk, with the private sector reaping the long-term rewards.

Moreover, relying on persuading the private sector to finance the necessary growth in SRI could be unnecessarily costly for society. The state (with the ability to issue gilts) and the Bank of England (with the ability to use QE) could in theory fund SRI ventures more cost effectively than private funding vehicles. We could end up with a system in which taxpayers take on the early stage risk and citizens end up paying more over the long term to develop SRI.

Recommendation 24: Stakeholders should develop collective investment and lending vehicles to allow institutional capital to be channelled into green finance/cleantech projects in a way that minimises costs and diversifies risks. A proportion of assets could be allocated to early stage ventures.

Recommendation 25: Social lending bonds should be established to allow funders to provide social loan capital for community based lenders to lend to underserved communities.

Recommendation 26: To help institutional investors such as pension funds and retail investors who value the benefits of passive management (but also want to avoid investing in listed companies whose activities damage the environment), campaign groups should work with investment industry experts to develop and promote a wider range of SRI index funds.

Recommendation 27: The privatisation of the Green Investment Bank does seem to have had a detrimental impact on the financing of green initiatives. There is a strong argument for having a national SRI Investment Bank to finance early stage ventures and take equity stakes in more established ventures (this would partly address the issue raised above about the state taking the risk and the private sector reaping the rewards).

Recommendation 28: The British Business Bank¹⁰⁵ should be given a specific objective to finance SRI projects, including providing venture capital for early stage SRI projects. The British Business Bank should establish a central resource of information on sources of government and other institutional funding for SRI projects.

Recommendation 29: Government should issue Sovereign Green Finance and Social Housing Bonds. Ten-year UK gilts are currently yielding 1.28 per cent, while longer-term 30-year gilts are yielding 1.79 per cent.¹⁰⁶ So, the UK government could raise money for SRI projects on very low terms. Private funders – whether through pension funds, insurers, or private equity funds – would expect a premium over and above this, which would mean higher funding costs that would have to be passed on to citizens.

Recommendation 30: NS&I should offer dedicated five-year Green Finance and Social Housing Bonds to allow citizen-savers/investors to play a part in funding SRI initiatives.

Recommendation 31: As well as national-level options, there is scope for local solutions. Government should support local authorities in developing community Social Housing and Green Finance Bonds to enable local citizens to play a role in financing SRI ventures. These bonds could be used, for example, to fund the upgrading of homes to higher environmental standards.

Policy objective 8: Developing the appropriate regulatory architecture, objectives and regulatory priorities

Recent positive interventions by policymakers and regulators (for example, the clarification of trustees' fiduciary duties) could help encourage lenders and investors to consider SRI in financial planning, and encourage greater citizen-investor engagement.

But this is not the same as having policy objectives to actively promote financial market behaviours and activities that contribute to SRI goals. This requires a change in the regulatory architecture, policy objectives provided to the key regulators and enhanced reporting of progress against objectives.

Recommendation 32: The Bank of England should be given a new statutory objective to promote financial market behaviours that contribute to economic and environmental sustainability.

Recommendation 33: The FCA and PRA should be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objective.

Recommendation 34: Responsibility for overseeing the disclosure and reporting of corporate SRI risk and performance should be transferred from the Financial Reporting Council to the FCA. Reporting against SRI risks should be made a statutory requirement (see above), with appropriate sanctions for non-compliance with reporting standards. The recommendations set out by the Task Force on Climate-Related Financial Disclosure¹⁰⁷ form a useful basis for a new system of reporting.

Recommendation 35: The FCA should oversee the development of a new SRI risk system as outlined in Recommendation 6 above.

Recommendation 36: The PRA is establishing a Climate Financial Risk Forum,¹⁰⁸ co-chaired with the FCA, to build intellectual capacity and share best practice on issues relating to climate-related financial risks. This is welcome. But, it is not enough.

Government and the Bank of England should establish a Financial Sustainability Committee (FSC) along the lines of the Monetary Policy Committee (MPC). The new FSC should take the lead in delivering the Bank of England's new sustainability objective and coordinate the work of all the regulators involved in promoting environmental and economic sustainability – the Bank of England, PRA, FCA and TPR.

Recommendation 37: The new FSC should publish an annual report on its activities plus a wider triennial review on its work. The FCA, PRA and TPR in their annual reports should also publish an assessment on how their activities have contributed to the work of the new FSC.

Policy objective 9: Increasing the supply of viable SRI financing opportunities

Progress is undoubtedly being made towards overcoming some of the legal and informational barriers that stand in the way of greater SRI financing. Moreover, the proposals in this report would also contribute to creating a more conducive regulatory framework and efficient, sustainable financial system supportive of SRI ventures.

But the problem remains that there is an insufficient supply of viable SRI opportunities. In other words, there is too much money chasing too few good opportunities.

The detailed policies needed to address this are outside the scope of this report. But, in almost every sector of the economy – transport and infrastructure, housing and building, utilities (water and sewage, electricity, gas), agriculture and food production, public services and local government, health and social care, manufacturing, construction, pharmaceuticals and chemicals – there are opportunities to introduce more environmentally friendly policies and green/clean technologies.

As mentioned, big corporates do not appear to be coming under sufficient pressure from shareholders or financial institutions to transform their operations. This transformation is unlikely to happen organically, and it will require a concerted long-term, government-led strategy to green the economy.

Recommendation 38: Building on the work of the Committee on Climate Change,¹⁰⁹ Government and relevant regulatory authorities should undertake a ‘green transformation audit’ of the main economic sectors to:

- assess the contribution each sector has made to the greening of the economy;
- evaluate the opportunities for transformation within that sector; and
- develop a transformation action plan for each sector.

Recommendation 39: Government should establish a single agency to be responsible for coordinating this transformation plan – either give responsibility to the Environment Agency or expand the role, powers and resources of the CCC.

Recommendation 40: This agency, along with the National Audit Office should develop new metrics to judge the performance of each sector, and publish annual updates and a formal triennial review of progress made against the transformation plan. The National Audit Office should be given lead responsibility for auditing progress reports.

The impact of Brexit

It would be remiss not to mention the potential impact of Brexit. In particular, the European Union has embarked on an ambitious Capital Markets Union project. As part of this, it has developed an Action Plan for Financing Sustainable Growth¹¹⁰ including developing common information standards to encourage investors to finance sustainable growth. In the absence of Brexit, the UK financial sector was expected to play a major role in these pan-EU initiatives. The UK financial sector may still do so, but until we see the final details of a deal, it is not clear what the impact of Brexit will be on:

- The opportunities for UK investors to fund SRI projects located in the EU – A hard Brexit might constrain access to a wider pool of potential investment opportunities or make these opportunities less attractive if the costs of investing rise due to the additional costs of doing business in the EU.
- The investor protection measures available to UK investors – In line with general fears about Brexit leading to a reduction in consumer protection available to UK consumers, there are fears that UK investment industry lobbyists will agitate for a reduction in investor protection on green investments on the basis that regulation is a ‘burden’ to encouraging greater levels of investment.
- The economies of scale for green finance/social impact investment vehicles – The UK was well placed to play the central role in the development of SRI impact investment vehicles and exchanges for use across the EU. This would have provided economies of scale for UK and EU investors that in theory would have reduced the costs of investing and enhanced the ability to spread risk. This could now be curtailed.

Recommendation 41: it is not yet clear how Brexit will affect the development of SRI initiatives in the UK. It very much depends on which form of Brexit we see the extent to which UK financial services retain access to EU markets, and whether the UK retains EU regulatory standards. Therefore, we recommend that policymakers and civil society collaborate on analyses to assess the implications of Brexit on the above points.

Notes

Summary

1. The Royal Bank of Scotland (RBS), one of the largest banks in the UK and the world, and a mainstay of the payments infrastructure, was within hours of running out of money in October 2008.
2. Bloomberg, 'The black hole engulfing the world's bond markets', 13 July 2019, <https://www.bloomberg.com/news/articles/2019-07-13/the-black-hole-engulfing-the-world-s-bond-markets-quicktake>
3. There is crossover with the commonly used ESG category, which stands for environmental, social and corporate governance. We do not include governance in our definition. Corporate governance refers to how companies are run, including the structure and role of company boards, management structures, the relationship between boards and executives, and executive remuneration.
4. Banks, asset managers, pension funds, insurers, hedge funds, private equity.
5. There will be double counting here as much of that wealth will be managed by financial institutions.
6. There is a great deal of crossover between our definition of SRI and ESG (see Note 3 above).
7. House of Commons Environmental Audit Committee, Sixth Report of Session 2017–19, Green Finance: Mobilising investment in clean energy and sustainable development, para 98, evidence received from Climate Bonds Initiative, January 2018.
8. This is a recurring problem with analysing data on SRI – the lack of good data.
9. Except under the most extreme circumstances.
10. Passive fund managers use techniques to track the performance of benchmark index such as the FTSE All Share Index. They do not actively buy and sell shares to try to beat the Index.
11. A term used to describe how financial institutions mislead investors and consumers about the degree to which their activities or products are aligned with environmental objectives.
12. Lenders, asset managers, insurers, pension schemes, investment consultants and other financial intermediaries.
13. TCFD, Final Report, June 2017, <https://www.fsb-tcf.org/publications/final-recommendations-report/>
14. See 'First meeting of the PRA and FCA's Joint Climate Financial Risk Forum', 12 March 2019, <https://www.bankofengland.co.uk/news/2019/march/first-meeting-of-the-pra-and-fca-joint-climate-financial-risk-forum>
15. The CCC is an independent, statutory body established under the Climate Change Act 2008. See <https://www.theccc.org.uk/publication/reducing-uk-emissions-2019-progress-report-to-parliament/>
16. European Commission Communication, Action Plan: Financing sustainable growth, 8 March 2018, COM(2018) 97 final, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN>

Introduction

17. Opinions differ on when the global financial crisis actually began. It certainly took hold in 2007, as can be seen by the collapse of Northern Rock in the UK. But it is generally held that the event which made people realise we were in a crisis was the collapse of the huge US investment bank, Lehman Brothers, in 2008. Therefore, for pre- and post-global financial crisis comparisons we use 2008 as the key date.
18. RBS, of the largest banks in the UK and the world, and a mainstay of the payments infrastructure, was within hours of running out of money in October 2008. The queues at Northern Rock when it failed were a small-scale rehearsal of what would have happened if RBS had been forced to close its branches and its ATMs had run out of cash.
19. If we did return to pre-global financial crisis levels, the costs would be painful given the levels of debt outstanding.

20. We use the term 'financing' to include the two primary activities of investing in and lending to, and hybrids of these two primary activities.
21. When we refer to 'investor' in this paper we include pension scheme members, insurance policyholders, retail investors (for example, through investment funds), and other citizens with an interest in how financial decisions are being made on their behalf – for example, citizens who want a say on financial decisions made by local councils.
22. 'Governance' refers to the way companies are run and deals with issues such as the leadership of a company, how boards function, executive pay, governance and controls, and shareholders' rights.

Section 1: The evidence on SRI

23. The Investment Association, Asset Management in the UK 2017–2018, 2018, The Investment Association Annual Survey.
24. Association of British Insurers, Key Facts 2018, p. 26, https://www.abi.org.uk/globalassets/files/publications/public/key-facts/key_facts_2018.pdf. Note that life insurers manage assets on behalf of pension funds so there will be some double counting.
25. European Banking Federation (EBF), 'UK banking sector facts and figures', September 2018, <https://www.ebf.eu/united-kingdom/>
26. Asset managers (on behalf of pension funds, insurers, retail investors), insurance companies, banks, and others such as specialist asset managers (hedge funds, private equity, etc.).
27. Bank of England, Quarterly Bulletin, 2015 Q2, 'Mapping the UK financial system'. Stripping out derivatives, the size of the financial system is £13 trillion.
28. There will be some double counting here, as assets held by households (pension schemes, insurance policies, savings accounts) will be included already in the data for banks, asset managers and insurers.
29. Towers Watson, Global Pension Assets Study, 2018, data as at end 2017.
30. With defined benefit schemes, the scheme sponsor (the employer) undertakes to provide a specified amount of pension in retirement to the employee. This income is determined by a formula based on the employee's earnings history, how long the employee has worked for the employer, age, and a conversion factor (such as receiving a pension equal to one-sixtieth of earnings for each year worked). With defined contribution schemes, the income on retirement received depends on how much employers and employees contribute to the pension scheme and the investment returns achieved on the assets held in the pension scheme.
31. Defined benefit schemes are still the largest in value terms because of the sheer size of legacy assets built up.
32. ONS, Occupational Pension Schemes Survey, UK: 2018, Figure 4: Active membership of private sector occupational pension scheme by status and benefit structure 2008 to 2018 <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/pensionssavingsandinvestments/bulletins/occupationalpensionschemessurvey/2018#what-are-the-different-categories-of-occupational-pension-scheme-membership>
33. Barnett Waddingham, 'Big Schemes Survey 2018: The end of DB pensions for active members edges closer', May 2018, <https://www.barnett-waddingham.co.uk/comment-insight/research/2018/05/02/big-schemes-survey-2018/>
34. Towers Watson Global Pension Assets Study, 2018, data as at end 2017.
35. Mercers European Asset Allocation Survey, 2018, p. 18.
36. Climate Bonds Initiative, Bonds and Climate Change: State of the market in 2016, sponsored by HSBC, Box: Climate Opportunity, p. 2 – this is based on estimates of investment needed to stay within the 2 degree world.
37. See IPCC, 'Special report: Global warming of 1.5 degrees', <https://www.ipcc.ch/sr15/> and <https://www.bbc.co.uk/news/science-environment-45678338>

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Section 3: Policy interventions to support greater SRI financing

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