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GREEN FINANCE – THE PENDULUM SWINGS

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Z/Yen, the team led by Alderman Professor Michael Mainelli, Chartered FCSI which delivers the Global Financial Centres Index, has turned its attention to global green finance for its latest index. This series will chart the progress of the world's financial centres towards a financial system that delivers sustainable development, and values people and the planet as much as profit. Mike Wardle, who ran the project at Z/Yen, explains the background. For further information, see a special interview with Mike Wardle on CISI TV.

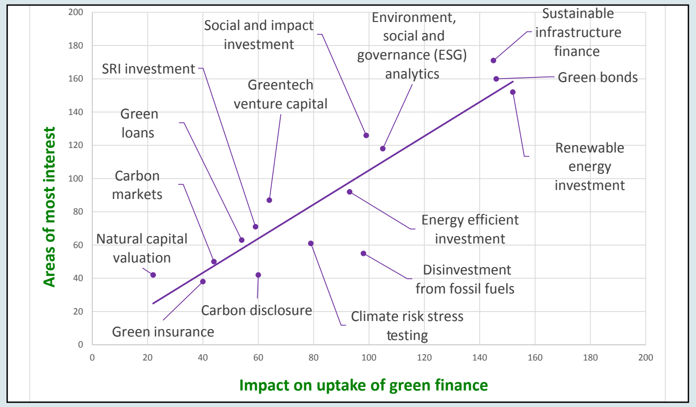

Chart 1: Relationship between areas of impact and interest

As we accelerate through the 21st century, the world is facing a number of significant challenges which will require unprecedented levels of investment in systems and infrastructure if they are to be overcome. The UN recognises the vitally important role of a sustainable financial system, which "serves the long-term needs of a healthy real economy, an economy that provides decent, productive and rewarding livelihoods for all, and ensures that the natural environment on which we all depend remains intact and so able to support the needs of this and future generations." [1]

Why an index?

Measurement is important, and this is reflected in the mantra of business management, 'we value what we measure'. As Mainelli and Harris point out, "environmental sustainability is a tough equation", [2] so the more data we have to work with, the better.

However, as Boyle states, we are often "exact about some of the least interesting things, but silent on wider and increasingly important truths".[3]

Measurement is only a means to an end. The purpose of measurement is to create the data from which information and knowledge emerge. Information and knowledge which can be used as the basis for sound decision-making and policy creation. We hope that this index will provide policymakers, businesses, academics and NGOs with data that can be used to facilitate the development of sustainable financial systems and the greening of financial products and services.

What are we seeking to measure?

The Global Green Finance Index (GGFI) seeks to measure perceptions of the quality and depth of green financial products across the world's financial centres. This leads to three questions:

- What is green finance?
- What is a financial centre?
- How can you measure quality and depth?

What is green finance?

Numerous organisations and institutions have developed their own definitions of green finance. The G20 defines it as the "financing of investments that provide environmental benefits in the broader context of environmentally sustainable development". [4] The OECD considers the term to be "stand-alone, a subset of a broader investment theme or closely related to other investment approaches such as socially responsible investing (SRI); environmental, social and governance (ESG) investing, sustainable, long-term investing or similar concepts." [5] Deutsches Institut für Entwicklungspolitik (DIE) defines it as the financing of public and private green investments (including preparatory and capital costs) in the following areas:

- environmental goods and services (such as water management or protection of biodiversity and landscapes)
- prevention, minimisation and compensation of damages to the environment and to the climate (such as energy efficiency or dams)
- the financing of public policies (including operational costs) that encourage the implementation of environmental and environmental-damage mitigation or adaptation projects and initiatives (for example feed-in tariffs for renewable energies)
- components of the financial system that deal specifically with green investments, such as the Green Climate Fund or financial instruments for green investments (eg, green bonds and structured green funds), including their specific legal, economic and institutional framework conditions.[6]

For the purposes of the Global Green Finance Index (GGFI), green finance refers to any financial instrument or financial services activity – including insurance, equity, bonds, commodity and derivatives trading, analytical or risk management tools – which results in positive change for the environment and society over the long term (sustainability). The most basic 'greenness' criterion of a company or project is that it contributes to reducing the emission of greenhouse gases. Over the past two decades, the rise of new financial instruments, such as green bonds, and environmental markets, such as carbon, forestry, or water services, along with advances in analytical techniques, have increased attention on green finance.

As demonstrated by its prominence in international policy discussions, such as in recent World Economic Forum meetings, green finance is no longer seen as a fringe activity, but a profitable and desirable sector, which drives financial markets, serves society and enhances the status of financial centres that demonstrate expertise.

The transition to a green economy, required if the world is to meet the targets laid down in the Paris Agreement, is a global investment opportunity estimated to be worth tens of trillions of dollars.[7] Vast investment is required for sustainable urbanisation in the face of a growing world population.[8] Financial services, if properly regulated and sized, are an essential component of a sustainable economy,[9] which meets the needs of stakeholders, enhances quality of life, protects the environment and addresses global issues such as climate change. However, there is still a long way to go: so far, only 5–10% of bank loans are 'green' [10] (based on data from the few countries where national definitions of green loans are available). Brown finance (finance flows that support carbon-intensive projects or activities) still massively overshadows green: G20 countries alone spent US$72bn annually in public finance on fossil fuel energy production between 2013 and 2015.[11]

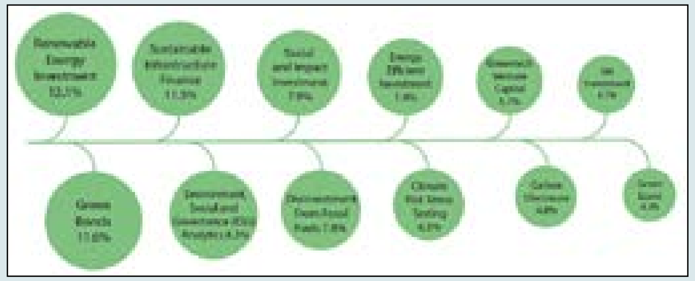

Chart 2: Activities with most impact on sustainability

Financial systems are failing effectively to reflect pricing signals and risk, as financial systems do not routinely take account of environmental costs or environmental limits. Four out of nine 'planetary boundaries' have been crossed: climate change, loss of biosphere integrity, land-system change, and altered biogeochemical cycles.[12] To help explore these issues, the GGFI gives a measure of how financial centres are responding to this challenge. We hope that enabling centres to compare their performance with their peers will improve policy makers' understanding of the drivers of green growth, and assist them in shaping financial systems to support sustainability goals.

For practical purposes, a financial centre often means a city with a stock exchange. UNEP defines financial centres "as cities with an intense concentration of financial activity involving an interlocking set of financial sectors and transactions." [13]

The approach to measuring quality and depth

Green financial products and services have been traded for over two decades, but until recently, volumes were quite small and trade tended to be primarily restricted to niche and domestic, rather than mainstream international markets. Measuring the quality and depth of green financial products across the world's financial centres presents a significant challenge. This has been recognised by the UN and other international bodies and has formed the focus of a number of initiatives, including UNEP FI's Positive Impact Initiative,[14] UNEP's Financial Centres for Sustainability Initiative,[15] Climate KIC, I4CE and PwC's Benchmark,[16] and UN PRI's Sustainable Stock Exchanges Initiative.[17]

The GGFI is complementary to these initiatives, as it seeks to use advanced statistical techniques to bridge the gaps in existing data by combining quantitative factors with the perceptions of financial services professionals and other experts. Another strength of this approach is that it is future-facing; combining the real-time opinions of practitioners with past performance data. As survey data for the GGFI is gathered on a continual basis and the intention is to publish updates twice a year, the index will be sensitive to real-time changes in the international policy environment and developments in financial services markets.

The survey asks for views on the penetration of green finance in a financial centre's overall financial activities. This reflects that the mix of financing activities, such as the ratio between green and brown financing, is important for sustainability. The survey also asks about the quality of green finance, enabling respondents to rate a financial centre independently from its market volumes. Thus, if a centre adopts weak green labelling standards in a bid to boost volumes, this may show up in the GGFI as a lower quality rating. This approach is designed to encourage a race-to-the top among financial centre policymakers. The GGFI, in combination with the other measurement initiatives listed above, will allow the identification of trends, and potentially enable policymakers to track the impacts of their decisions and identify and fill data gaps.

Areas of green finance: impact on sustainability

Alongside the ratings of penetration and quality in the GGFI questionnaire, the project asked additional questions about the development of green finance. These focused on: areas of green finance considered most interesting by respondents; areas of green finance with most impact on sustainability; and factors driving the development of green finance.

We asked respondents to identify the four areas of green finance which they considered had most impact on sustainability. The results are shown in Chart 2 (left). The top areas listed are: renewable energy investment; green bonds; sustainable infrastructure finance; environment, social and governance (ESG) analytics.

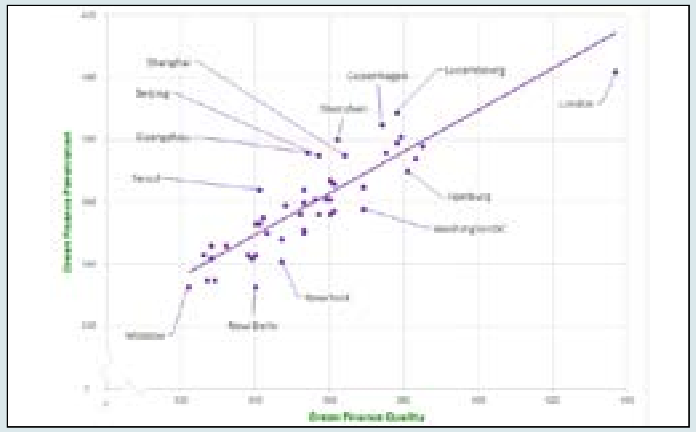

Chart 3: Relationship between penetration and quality

Interest, impact and penetration

Chart 3 shows the relationship between ratings of penetration and quality in the index. The ratings are universally low, however, this chart shows the generally close correlation between the assessments of each factor by respondents.

Looking at the areas of green finance respondents identified as interesting and those they considered had most impact, we see a close correlation, as shown in Chart 1. Disinvestment from fossil fuels stands out as further from the trendline, reinforcing that its impact was judged greater than the interest shown in it as a green finance activity.

Key results of initial survey

Western Europe does well, featuring nine of the top ten centres in the quality index and seven of the top ten in the penetration index. 21 of the 47 centres in the index are in Western Europe. London comes top for both measures, closely followed by Amsterdam for quality and Luxembourg for penetration. Only 58 points separate the top five centres for quality and just 21 points for penetration.

San Francisco and Washington come equally in tenth place in the ranking as the top North American centres in the quality index. San Francisco is also the top North American centre in the penetration index. Despite being acknowledged as one of the world's top financial centres, New York is significantly outperformed by other North American centres in the GGFI.

Shanghai and Shenzhen are top in the Asia Pacific region for quality and penetration respectively. Chinese centres all perform well and are closely clustered in terms of ratings.

Endnotes

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