SUSTAINABLE FINANCIAL SYSTEM, PRINCIPLES, IMPACT

SUPPLEMENTARY REPORT

JUNE 2016

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INTRODUCTION

This document supplements the PRI's formal consultation document Sustainable Financial System, Principles, Impact, specifically the "Developing a sustainable financial system" section.

It explains the PRIs proposed framework for contributing to a sustainable financial system in more detail, to make our thinking clear for signatories and stakeholders interested in a deeper discussion of the PRI's work in this area.

There are no consultation questions in this document. Any insights or questions arising from reading this document should be included in responses to the consultation document questions.

Sections 3 – 6 of this document relate directly to sub-sections of the consultation document: "scope of the financial system", "analysis of underlying causes and consequences", "drivers of change" and "criteria for selecting projects".

A third document, Sustainable Financial System Literature Review summarises the various analyses of the financial system by international institutions, academics, think tanks and investors that we used in preparing this consultation.

As well as providing an opportunity to give written feedback, the PRI is conducting a series of workshops and follow-up meetings with signatories from May to September 2016, including sessions at PRI in Person in Singapore. PRI in Person will also see the feedback received to date presented to signatories for their consideration.

DEVELOPING PRI'S PROGRAMME OF WORK

The PRI's formal consultation document (Sustainable Financial System, Principles, Impact) sets out the PRI's Mission statement, which includes reference to supporting a sustainable financial system.

In this section we explain the steps the PRI has taken to prepare the framework for our work on a sustainable financial system and the content for the consultation document.

Why is the PRI doing this work?

As a key part of the financial system, investors have a central role to play in ensuring that the system fulfils its purpose and serves society, and the PRI's Mission statement calls for signatories to play a role in supporting a sustainable financial system by "addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation".

Responding to this, the PRI established the Sustainable Financial System programme to develop a framework for contributing to a sustainable financial system. We propose to use this framework to guide a dialogue between signatories and to inform action that investors can take.

We will use the framework to identify five to ten areas of the financial system that the PRI can contribute to changing. Below, we provide a high-level overview of the steps involved.

July 2015 – May 2016

- Reviewed literature describing existing work on the financial system and systemic risk
- Considered the purpose of the financial system and the role it plays in society
- Considered the desirable characteristics of a financial system fit for that purpose
- Established how much of the financial system the PRI should consider (e.g. which participants/actions)
- Analysed factors driving changes to the financial system
- Analysed risks and sustainability challenges facing the financial system
- Developed a list of underlying causes and consequences of an unsustainable financial system

Sustainable Financial System, Principles, Impact formal consultation
Supplementary report
Literature Review

May 2016 – March 2017

- Consult with signatories and stakeholders on the framework
- Prioritise areas of the financial system for the PRI and signatories to work on
- Deepen our understanding of possible interventions or projects
- Prioritise interventions to pursue
- Finalise frameworks to measure the effectiveness of our work

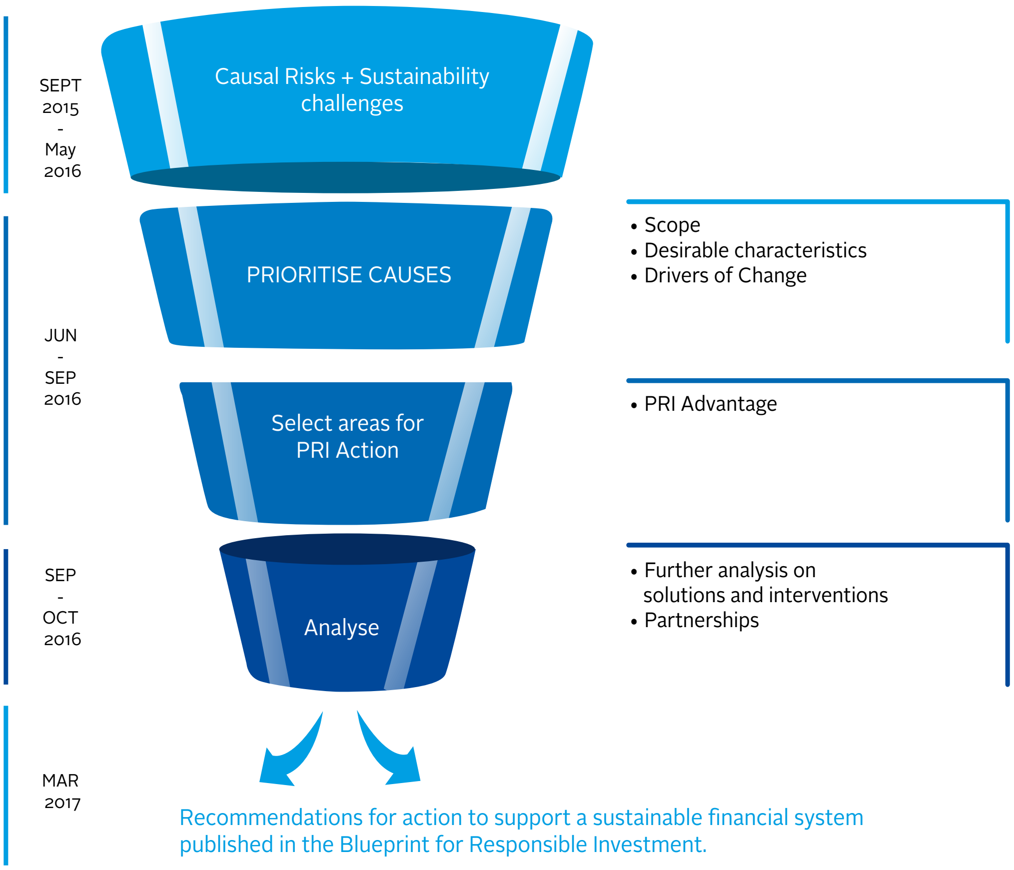
Blueprint for Responsible Investment

March 2017 onwards

- Implement the priority projects and interventions
- Monitor the drivers of change in and outside the financial system
- Refine the framework and priorities as required

As the work continues over subsequent years, it will be monitored as an integral part of the PRI's regular business plans and reported on in signatory communications including annual reports.

Our Analytical Approach



SCOPE AND CHARACTERISTICS

SUSTAINABLE FINANCIAL SYSTEM

The PRI's formal consultation document (Sustainable Financial System, Principles, Impact) sets out the broad arguments for why investors should act on the financial system. It also sets out the PRI's views on the areas where the PRI and its signatories are likely to have the most influence.

In this section, we develop these arguments, providing an expanded discussion of the reasons for investors to take action, and some reflections on the characteristics of a sustainable financial system. We also set out what we see as the scope of the financial system.

Why investors should act[1]

As discussed in the PRI consultation document, the financial system is an integral part of modern economies, and makes an important contribution to societal well-being. It enables individuals, organisations and governments to reliably store and access their income and assets for present and future use. It provides capital to support productive investment, innovation, and present and future consumption and, ultimately, should support sustainable and equitable economic development.

Sustainable development

"Sustainable development [...] meets the needs of the present without compromising the needs of future generations to meet their own needs."

The Brundtland Commission (2007)[2]

This definition of sustainable development requires that attention be paid to:

- economic growth;
- environmental impacts (in particular, those that are covered by the UN Framework Convention on Climate Change and successor treaties and protocols, the Convention on Biological Diversity and other international instruments).
- social impacts (in particular, those that are covered by the International Bill of Human Rights, the Core ILO Conventions and the UN Guiding Principles on Business and Human Rights);
- development issues (recognising in particular that the United Nations Sustainable Development Goals aim to stimulate concrete action on economic development, on environmental protection and on social issues between 2015 and 2030).

1 This section builds on the Sustainable Financial System Literature Review. It has been particularly informed by the following:

- Kay, J. (2015), Other People's Money (Profile Books, London), p. 6 which identifies the four functions of the finance sector as the payments system, the matching of borrowers and lenders, the management of household financial affairs, and the control of risk.
- UNEP Inquiry into the Design of a Sustainable Financial System (2015), The Financial System We Need: Aligning the Financial System with Sustainable Development. October 2015 (UNEP, Geneva) and Waygood, S. (2015), A Roadmap for Sustainable Capital Markets: How can the UN Sustainable Development Goals harness the global capital markets? An Aviva White Paper (Aviva, London), which explore how to align the finance system with sustainable development.
- Focusing Capital on the Long Term (2015), Perspectives on the Long Term: Building a Stronger Foundation for Tomorrow, which presents a series of opinion pieces on how the economic system may be made more stable and on how resources might be allocated to provide the greatest value for the broadest range of stakeholders.

2 World Commission on Environment and Development (1987) ['The Brundland Report'], Our Common Future (Oxford University Press, Oxford).

Despite these important contributions, the financial system does not function as effectively as it should. It does not always exhibit the characteristics that market participants would typically associate with being sustainable, such as being fair, resilient, transparent, efficient, inclusive, well-governed and aligned with society's needs.

The financial system is also susceptible to risks and sustainability challenges. These can emerge from a variety of sources: the relationship between investors and companies; the relationship between companies and their managers, owners, beneficiaries and advisers in the investment chain; the operation of investment markets. They can also emerge from outside the investment system itself.

Some risks and sustainability challenges, whether they lead to specific shock events or accumulate over time, can limit the ability of the financial system to operate efficiently and equitably. They can also undermine the ability of fiduciaries and other institutional investors to fulfil their purpose. This is undoubtedly material to investors, in particular asset owners, who have a responsibility to minimise risk and maximise returns over the longer term.

Key concept: Systemic risk

In order for a risk to be systemic, the consequences of a risk accumulating or materialising must be carried beyond individual actors and actions within the system to threaten the system itself. For example, the Systemic Risk Centre at the London School of Economics describes systemic risk as: "[referring] to the breakdown of an entire system rather than simply the failure of individual parts. In a financial context, it captures the risk of a cascading failure in the financial sector, caused by interlinkages within the financial system, resulting in a severe economic downturn."[3]

For the purpose of PRI signatories, a reasonable test of "breakdown" may be that fiduciaries and other institutional investors are undermined or significantly constrained from fulfilling their duties to beneficiaries.

Institutional investors should consider how the financial system as a whole operates because its design, its effectiveness and its resilience to risks and sustainability challenges influences their performance.

Many signatories find that they are making limited progress on responsible investment, investing in a manner that damages the economy and the natural environment, because the broader financial system does not incentivise sustainable economic development. They can – and should – work together to identify and address underlying conditions that cause this.

Without pre-empting the identification of specific actions that could result from this consultation, these underlying conditions could be addressed through policies and practices that:

- enable capital to be allocated more efficiently and equitably;
- enable individuals, organisations and governments to transact – to invest, pool risk and manage money;
- make the financial system itself stable and resilient;
- correct the risks created or exacerbated by the financial system's operations;
- align the financial system's activities and objectives with the limits of the natural environment and the needs of a fair and equitable society.

3 http://www.systemicrisk.ac.uk/systemic-risk

Scope of the financial system for this work

For the purposes of the PRI's work on a sustainable financial system, the scope of the financial system:

includes

as its primary focus, the investment value chain – the parts of the investment system that are closest to PRI's membership and where PRI is likely to have the most direct influence – including:

- beneficiaries (e.g. savers, insurance policy holders);
- asset owners (e.g. pension funds, (re)insurers);
- investment managers, advisors and service providers (e.g. investment consultants, rating agencies, investment banks);
- companies and issuers, securities exchanges and related regulators/regulations.

as its secondary focus, the parts of the investment system where, while important to PRI's membership, the PRI has less direct influence – including:

- macro prudential authorities (e.g. those responsible for wider monetary and economic policy settings);
- the banking sector (including its role as a source of credit to companies).

excludes:

retail financial advisors, banks as deposit-taking institutions, credit providers to individuals, retail financial regulation/ regulators (with the exception of managed investment schemes).

In defining the scope in this way, we wish to delineate between the roles and responsibilities of the public and private sector, specifically that governments are responsible for regulation, tax and distribution policy.

The characteristics of a sustainable financial system: initial reflections

In the course of the research underpinning the PRI's formal consultation document (Sustainable Financial System, Principles, Impact), we have canvassed the views of the PRI policy committee, the SFS Advisory Group, various external experts and PRI staff on what they see as the characteristics of a sustainable financial system. In the table below, we present our current longlist of the characteristics of a sustainable financial system.

Canvassing views on the characteristics of a sustainable financial system

- In December 2015, we commissioned Brett Scott (the author of The Heretics' Guide to Global Finance) to prepare an overview of financial system reform efforts and innovations. As part of this report, Brett summarised the characteristics that NGOs and civil society organisation would like the finance sector to have.
- In January 2016, we sent a short survey to the PRI Policy Committee and other external experts, and to key staff within PRI. One of the questions asked respondents to suggest three to five key characteristics of a sustainable financial system.
- We presented the consolidated findings from these exercises to the PRI Board in February 2016, and to the SFS Advisory Group in February 2016 and April 2016.

We note that these characteristics are inter-related. Some may reinforce each other (a financial system that encourages ethical decision-making frameworks may well also be a fairer financial system) and some may conflict with each other (reduced intermediation may be a characteristic of a simpler financial system but may increase risks to customers, or increased transparency on fees may reduce willingness to conduct or pay for high-quality research on social and environmental performance and impacts), so it may be necessary to accept a trade-off between characteristics.

We intend to further develop this list as we proceed through the consultation process, and we welcome feedback. We expect to consolidate and/or prioritise this list before defining which aspects to act on.

Characteristics of a sustainable financial system

Characteristic	Commentary
Productive	The financial system should support wider economic development. This includes, but is not limited to, efforts and activities that: • improve productivity; • create employment; • support economic growth; • improve societal well-being; • reduce inequality.
Transparent	This includes transparency on fees, by companies and investors on social and environmental performance and impacts, and on financial performance and returns. This information should be accurate, timely and publicly available. This information should be presented in a manner that allows stakeholders to holistically assess: the contribution to value creation of individual actors (e.g. companies, asset owners, investment managers) and of the financial system as a whole; the risks and opportunities associated with these actors and with the system as a whole. While transparency itself is not a guarantee that the financial system will function as intended, its absence means that accountability mechanisms (regulatory, self-regulatory, market-based) cannot function effectively.

Characteristic	Commentary
Well-regulated and well-governed (including effective accountability processes)	We use the terms "regulated" and "governed" to acknowledge that governance processes in the financial system include regulatory, self-regulatory and market-based processes. Actors charged with regulating or governing the system include government, regulatory bodies, industry bodies, investment institutions, clients, beneficiaries or other stakeholders, and these actors often work together. A well-regulated and well-governed financial system will have: • actors that are capable of intervening where needed; • actors that are willing to intervene where needed; • monitoring and reporting processes that provide actors with the information they need in a timely manner to deliver on their regulatory or governance roles. • regulatory or governance frameworks that enable actors or institutions to intervene where necessary; • regulatory or governance frameworks that require appropriate standards (e.g. fiduciary standards) of behaviour in all parts of the financial system; • regulatory or governance frameworks that ensure that the financial system supports sustainable and equitable economic development; • robust accountability processes throughout the system. The requirements for effective regulation and governance can be considered in two distinct areas: • where there is regulation or governance processes that are not effective because they are poorly designed or implemented; • where regulation or governance processes are absent or where their breadth, depth and quality have not kept pace with the market (e.g. new actors and means of exchange emerging as a result of technology developments, with consequent implications for consumer/investor protection).
Fair and equitable	This includes: • access to the financial system, or to financial services, for all (accessibility and affordability); • fair treatment of all actors within the system, akin to the fiduciary duty of loyalty which requires fiduciaries to impartially balance the interests of different beneficiaries; • delivering expected (or promised) benefits for beneficiaries and clients; • the actors bearing the risks (including externalities and other spill-overs) receiving the returns. • aligning incentives along the investment chain (i.e. addressing principal-agent issues).
Informed	This requires that savers and beneficiaries have: • sufficient knowledge to make informed decisions; • investment professionals that understand their needs and interests; • the ability to critically evaluate and understand the data and information provided by other actors. (This requires that information is available in a form that enables savers, beneficiaries and other actors to make appropriately informed decisions.)

Characteristic	Commentary
Participatory	This includes stakeholders being involved not just in decisions that affect them or their objectives, but wider decisions about the purpose and structure of the financial system itself.
Socially and environmentally sustainable	This includes: • comprehensively identifying and assessing of social and environmental impacts and risks in decision-making processes; • capital allocation decisions that may encompass, amongst others, socially useful finance, not financing further fossil fuels, divestment movements, and sustainable investment; • internalisation of externalities in decision-making; • delivering identifiable positive environmental and social impacts; • proper pricing of environmental and social impacts and of risks.
Ethical	This involves fiduciaries and financial actors using decision-making frameworks that explicitly account for beneficiaries' and customers' interests as an integral part of decision-making (i.e. financial factors are maximised in the context of principles such as "do no harm").
Simple	Many of the problems identified in the financial system stem from its complexity. A simpler financial system would be expected to have less intermediation, less complexity (e.g. on products) and clear accountabilities for financial performance and for wider social, environmental and economic impacts.
Efficient	Capital should be deployed to support productive investment, innovation and present and future consumption. This requires accurately assessing risks and opportunities, and properly integrating them into investment decisions. Transaction costs should be minimised, including those associated with: • assessing financial risks and opportunities; • assessing sustainability-related risks and opportunities; • matching borrowers and lenders; • enabling individuals, organisations and governments to access the financial system; • monitoring and overseeing the actors in the financial system and the financial system as a whole.
Resilient	A resilient financial system should: • consistently deliver on its purpose, without undermining the system itself or related systems upon which it relies to perform its functions; • be based on long-term thinking; • be adaptable to change (e.g. type of participants, technology); • be stable (i.e. not prone to dramatic changes in actors, in practices, in performance).

CAUSES AND CONSEQUENCES

The PRI's formal consultation document (Sustainable Financial System, Principles, Impact) lists over 30 underlying causes of an unsustainable financial system and over 60 consequences of those causes.

In this section, we describe the process we followed to identify those causes and consequences from a longlist of perceived risks to the financial system. We also present the underlying causes with their descriptions and the full list of consequences.

The financial system is complex. It is composed of many actors with multiple interactions and there are multiple points and mechanisms of influence. The financial system also interacts with other systems in society and these systems in turn influence the financial system.

To change a complex system, it may be necessary to address multiple conditions or influences in the system at the same time or in a particular sequence. It may also be possible to identify critical leverage points that cause change to move through the wider system.

The short-term objective of our work is to identify and sufficiently define five to ten conditions or influences that could be addressed to contribute to a more sustainable financial system. We will then conduct more analysis to identify projects or interventions that we can make.

In order to prioritise and focus on the most important conditions, we have used a framework that identifies underlying causes of an unsustainable system, and negative consequences of those causes. (Although many of these causes also have positive consequences, we are focusing on the aspects that introduce risk to the financial system or to society.)

We acknowledge that the underlying causes we have identified may have further causal factors influencing them. We believe that through the consultation process with signatories, we will be able to resolve a set of useful underlying causes on which to focus our work.

In the financial system, there is not a simple, two-tiered split of causes and consequences: consequences of one cause can in turn be causes for another set of consequences. Accordingly, we have identified something as a "cause" at a point that makes most sense not just from an analytical perspective, but also from an implementation perspective, i.e. they are problems where it is possible to envisage effective interventions).

Causes and consequences create feedback loops in the financial system, which can be reinforcing (or amplifying) or they can be balancing (or attenuating). It is the net effect of these interactions that is of primary concern.

We arrived at a list of over 30 causes and over 60 consequences as a result of the following steps.

First, we created an initial list of risks and sustainability challenges facing the financial system, based on an analysis conducted with PRI staff and an assessment of the risks identified in the Literature Review. This list was subsequently refined based on discussions with the Sustainable Financial System Advisory Group and with external stakeholders. This gave us a list of nearly 140 risks.

We then categorised these areas of risk and opportunity into four areas:

- The relationship between owners and managers of capital (later renamed as "The relationship between investors and companies")
- The delegated investment chain (later renamed as "The relationship between investors and managers, owners, beneficiaries and advisers in the investment chain")
- The nature of the marketplace (later renamed as "The operation of markets in which we invest")
- Externalities to the economy, e.g. global resource depletion (later renamed as "Externalities")

In dividing risks and opportunities in this way we noted that there were overlaps and interactions between the four categories. The first three of these categories align with the manner in which we have defined the scope of the financial system, with the fourth relating to the broader context within which it sits.

While we delineate between the financial system and the wider economy, we are clear that the financial system is an integral part of the wider economy: many aspects of the wider economy depend on the core functions of the financial system and many of the core functions of the financial system depend on the shape, functioning and health of the wider financial system.

We then organised the risks into underlying causes and consequences. We did this in a workshop with the SFS Advisory Group through a discussion that identified cause and effect relationships between the risks. The risks that were seen to influence or contribute to many of the other risks were identified as underlying causes. This approach does not rule out a potential intervention to address a consequence, if that consequence is influential in the system in its own right. Our view, however, is that working on the underlying causes is likely to provide the most useful insights for meaningful reform. It is also useful in considering the operation of the system as a whole.

Organising risks and opportunities in this way also reflects the fact that many of the issues we are concerned about are symptomatic of underlying causes, rather than issues that should be directly addressed in their own right. For example, excessive corporate remuneration is a consequence of weaknesses in shareholder or investor oversight processes, which in turn may be caused or exacerbated by inadequate regulation and by diversified ownership (which limits the willingness and ability of investors to act on remuneration). While efforts to address excessive corporate executive remuneration directly may produce results in the short term, it is likely that the problem will arise again if these underlying conditions are not addressed.

The relationship between investors and companies

Cause	Description
Diversification of investment, and loss of ownership control in corporations	This relates to investors with diversified portfolios having lower shareholdings in individual companies, such that their engagement and ability to influence company management and large or dominant shareholders is limited.
Weaknesses in corporate governance regulation, limiting ownership control	This relates to weaknesses in corporate governance regulations (e.g. those affecting shareholder rights) or, in many markets, the weaknesses in the enforcement of those regulations.
Principal-agent relationship	This relates to the challenges in ensuring that company management acts in investors' interests rather than in their own personal interests. It requires investors to pay attention to the incentives given to company management (both in terms of the scale of the incentives and in terms of the behaviours and practices that are encouraged as a result). It also requires investors to pay attention to issues such as corrupt or unethical behaviour, and situations that could give rise to these sorts of behaviours (e.g. related party transactions).
Lack of incentive to encourage or require sustainable business activity	This relates to situations where market or regulatory incentives are not sufficient to encourage the company to act in a sustainable manner, i.e. in a manner that is aligned with sustainable economic development.
Lack of transparency by companies and investors in terms of how they address ESG issues	This relates to the lack of transparency by investors on how they take account of ESG issues in their investment processes, and the lack of transparency by companies on their ESG practices and performances. It also relates to the lack of integration of ESG issues into wider business and investment performance.
Short-term focus on financial returns	This relates to investors' emphasis on short-term financial performance. (A range of causal factors and consequences in the system influence this short-term focus and behaviour. We will examine these factors further in future stages of the programme.)
Lack of attention to ESG issues in investment research and decision-making	This relates to investors' emphasis on financial performance (both at the level of the individual investment and at the portfolio level) and the corresponding lack of emphasis placed on ESG issues. (In many ways this is a symptom of other causes, in particular the lack of incentive to encourage or require sustainable business activity, and the short-term focus on financial returns.)

Consequences

- Shareholders ill-equipped to hold boards to account
- Misaligned corporate remuneration scale and structure
- Misaligned incentives
- Lack of financial materiality of many ESG issues
- Lack of recognition of the potential financial materiality of ESG issues
- Ineffective accountability processes
- Lack of reflection on ESG or sustainability issues
- Asymmetric information between the owners (investors) and managers (corporations) of capital
- Increased transaction costs associated with monitoring and oversight
- Lack of attention to sustainability impacts
- Short-term strategy and incentives (company and investor)

The relationship between investors and managers, owners, beneficiaries and advisers in the investment chain

Cause	Description
Lack of attention to wider beneficiary interests	This relates to the lack of attention to wider beneficiary interests (beyond financial returns), and the extent to which those interests are aligned with the wider interests of society.
Cultures, values and decision-making process within the investment system	This relates to unethical behaviours, lack of attention to beneficiary interests and prioritisation of short-term performance (and financial rewards) over long-term performance.
Principal-agent relationships (Intermediation)	This relates to the manner in which principals can and do monitor and oversee their agents. The complexity and length of the investment chain, together with misaligned incentives throughout, make this extremely difficult.
Lack of alignment between the financial system and sustainability goals	This relates to the externalities and other market failures that limit the incentive for asset owners to pay attention to sustainability-related issues.
Short-term focus on financial returns	This relates to the incentives for agents to focus on short-term drivers of financial performance, and to pay correspondingly less attention to long term performance and sustainability-related impacts. (A range of causal factors and consequences in the system influence this short-term focus and behaviour. We will further examine these factors in future stages of the programme.)
Investor practices and process (e.g. governance, risk assessment, [skills, knowledge, beliefs, values] disclosure)	This relates to investors' ability to effectively monitor their agents and to ensure that their beliefs and principles are driven through the investment chain.
Lack of transparency (e.g. managers to owners, owners to beneficiaries, advisors to clients)	This relates to transparency between all of the actors in the intermediated investment chain, and the relationship of transparency to monitoring practices and performance.
Weaknesses in regulation (including lack of clarity on overall governance of financial system)	This relates to the rights given to investors to hold their agents to account, and to the rights given to beneficiaries to hold asset owners to account.
Insufficient attention to "do no harm"	This relates to the requirements on asset owners and other investment actors to pay explicit attention to social and environmental issues in their investment practices and processes. It also relates to the weight assigned to these issues in investment decision-making.
Disconnect between investment decisions and the economy	This relates to the level of attention that investment actors are required to pay to the wider economic impacts of their activities, and of the impacts of the financial system as a whole on the wider economy.

Consequences

- Misaligned relationship between fiduciary duty and the broader interests of society
- Disempowerment of consumers/savers/beneficiaries
- Limited financial literacy of consumers/savers/beneficiaries
- Limited ESG literacy and capabilities of consumers/savers/beneficiaries
- Lobbying, and resulting weaknesses in regulation and oversight
- Accountability, incentives and remuneration structures
- Misaligned incentives (e.g. direct chain and service providers), and lack of alignment of interests
- Limited ESG capacities and expertise of asset owners
- Lack of demand for sustainability-related products and services
- Limited consumer/saver/beneficiary engagement
- Lack of attention to ESG issues in investment research (credit and equity)
- Lack of accountability for ESG performance and impacts
- Multiple weaknesses in relationships between the investment and the banking sector
- Mandate design favouring short-term performance
- Short-term investment strategies including high frequency trading
- Limited sustainability governance and capabilities of investors
- Investment beliefs and risk management practices focusing on transferring rather than managing risk
- Toxic behaviours such as latency arbitrage and internal trading platforms (dark pools)
- Lack of accountability for ESG performance and impacts
- Lack of asset owner accountability to beneficiaries
- Markets not meeting or delivering on long-term societal needs

The operation of markets in which we invest

This relates to the operation of markets and the behaviour of participants, as influenced by the manner in which these markets are structured and regulated.

Cause	Description
Lack of alignment between markets and sustainability goals	This relates to externalities and other market failures which limit the incentive for asset owners and investment managers to pay attention to sustainability-related issues.
Lack of policy maker understanding of the best levers to drive or motivate investor behaviour	This relates to the capacity and expertise of policy makers to relate incentives to sustainability concerns, and the implications for policy design and implementation.
Incoherence or inconsistency in government policies	This relates to the design of policy in terms of how effectively it provides incentives for investors to take account of sustainability related concerns in their investment processes. (We note that policy makers are often attempting to address conflicting policy objectives).

Cause	Description
Lack of transparency	This relates to transparency along the entire investment chain, as well as transparency about the relationship between the financial system, the economy, society and the environment. It also relates to the role that transparency plays in investors' (and other stakeholders') ability to monitor practices, processes and impacts both within and external to the financial system.
Weaknesses in oversight of the financial system by regulators and market authorities	This relates to the manner in which the roles and responsibilities of regulators and market authorities are both designed and implemented.
Short-term focus by market actors (e.g. exchanges, brokers)	This relates to the incentives for agents to focus on short-term drivers of financial performance, and to pay correspondingly less attention to long-term performance and sustainability-related impacts. (A range of causal factors and consequences in the system influence this short-term focus and behaviour. We will further examine these factors in future stages of the programme.)
Common investment strategies and common investment advice	This relates to the tendency for investors to make similar assumptions (e.g. about liquidity), to take similar actions and to make similar investment decisions at the same point in time.

Consequences

- Lack of understanding among governments of what good ESG regulation looks like
- Incomplete accounting and valuation standards
- Relationships between credit rating agencies and companies or issuers being rated
- Investor impunity for the negative ESG impacts of investments (lack of accountability for individuals and institutions)
- Weaknesses in corporate disclosures on ESG issues (lack of standardisation)
- Lack of consideration of ESG issues in investment decision-making (because of externalised costs, market failures)
- Poor understanding of investment activities' impact on the economy
- Lack of incentives for long-term behaviours (e.g. loyalty driven securities, tax advantages for long-term investors)
- Lack of clear reporting frameworks (to ensure consistent, meaningful reporting)
- Poorly integrated financial regulation
- Lack of attention to unintended or undesirable consequences (e.g. liquidity and capital rules constraining the availability of capital for green investments)
- Increased transaction costs associated with monitoring and oversight
- Inefficient markets
- Inappropriate cultures and values within the financial system
- Short-term return-seeking behaviour (e.g. pressure to narrow funding deficits)
- Short-term investment strategies including high frequency trading
- Amplification of impacts, e.g. pro-cyclicality, herding, market bubbles

Externalities

This relates to the interactions between the financial system and the rest of the economy, noting that (a) each influences the other, and (b) the financial system is an integral part of the wider economy. It includes spill-over effects, externalities, corporate behaviour, and environmental and social issues.

Cause	Description
Policy incoherence or inconsistency (sustainability policy), leading to market failures and externalities	This relates to the externalities and other market failures that arise as a result of weaknesses in policy design and which, in turn, limit the incentive for asset owners and investment managers to pay attention to sustainability-related issues.
Ineffective policy implementation and oversight (coordination and implementation of policies that are there)	This relates to the weaknesses in the monitoring and implementation of policy and the limiting of the incentives for investors to take account of ESG/sustainability-related concerns in their investment processes.
Common law precedents	This relates to court judgements that limit the incentive for investors to take account of ESG/sustainability-related concerns in their investment processes.
Capture of policy by vested/ sectoral interests	This relates to the influence exerted on the policy process by organisations seeking to limit the incentive for investors to take account of ESG/sustainability-related concerns in their investment processes.
Inadequate financial policy to address sustainability challenges	This relates to weaknesses in financial policy, and to the potential tensions between financial policy and other forms of policy goals, which can limit the incentive for investors to take account of ESG/sustainability-related concerns in their investment processes.
Governance and regulatory failings	This relates to weaknesses in wider market and societal governance, e.g. bribery, corruption, political instability, conflict.
Lack of attention to the social and environmental consequences of investment	This relates to pressure on investors to focus on short-term drivers of financial performance, and to pay correspondingly less attention to long-term performance and sustainability-related impacts.
Growth paradigm	This relates to the framing of economic success in terms of growth (in GDP, in consumption, in standards of living), and how this leads to over-consumption of natural and other resources.

Consequences

- Lack of demand for sustainability-related products and services
- Lack of innovation in sustainability-related products and solutions
- Inadequate or misallocated capital flows
- Inadequate/ineffective incentives
- Limited investment in markets with governance and sustainability challenges
- Inequitable distribution of the costs and benefits of investment and related activities (e.g. unemployment following the financial crisis)

Example environmental and societal impacts

The following are examples of the impacts on the natural environment and society that can arise from the causes and consequences identified above. Although the PRI may work to address some of these in its existing activities aimed at actors within the financial system, our work in this programme addresses the contribution of the financial system itself.

- Fossil fuel usage
- Excessive greenhouse gas emissions
- Climate change and its associate impacts
- Natural resource depletion, e.g. water, forests
- Damage to ecosystem services (e.g. reduction in pollinators, biodiversity)
- Unemployment and poverty
- Human rights infringements
- Quality of and priorities for economic growth
- Drain on government finances
- Political instability
- Inequality (financial)
- Inequality (risks and benefits)
- Bribery and corruption
- Limited access to water
- Pollution
- Toxic/hazardous chemicals (management, disposal)
- Access to land/land rights

DRIVERS OF CHANGE

The PRI's formal consultation document (Sustainable Financial System, Principles, Impact) describes factors that are likely to drive changes to the financial system.

In this section, we describe the process we went through to identify and describe these drivers of change, and we discuss their relevance to our work on a sustainable financial system.

One of the key challenges for our work on a sustainable financial system is ensuring that any interventions made are relevant to the financial system of the future. This will partly be addressed through standard project monitoring/review and corresponding adaptation, but also means being forward-looking in designing and implementing interventions so that they do not focus on problems that are less likely to exist in the future, on actors whose influence drops, or on interactions or relationships that will be less important. This must be balanced against addressing the pressing challenges in the present financial system.

Some important drivers of change are already acting on the system, and some of their effects are already being seen, but predicting the broader future is fraught with uncertainty: it is difficult to identify the key drivers of change and even more difficult to predict what the resulting system of the future will look like, in terms of its structure, actors, influences, power, relationships, impacts, needs, etc.

Accordingly, we started by clarifying that our aim was not to generate a definitive list of all of the drivers that are acting on, or are likely to act on, the financial system. Nor was it to generate a definitive set of predictions about the financial system of the future. Rather, our aim was to generate a reasonably short list of driving forces that we can expect to have a significant impact on the financial system, i.e. can the PRI be reasonably confident that the interventions it decides to make are likely to be relevant to the future?

This impact could be on:

- the actors in the financial system (potentially including the introduction of new actors and the removal of existing actors);
- the relationships between actors (including the introduction of new relationships and the removal of existing relationships);
- the financial system (either on the system itself or on the relationships between the financial system and wider society).

We also wanted to identify whether the identified drivers are likely to create new issues that may be the subject of PRI interventions in the future.

To develop this list, we went through the process set out on the next page.

Canvassing views on the drivers of change to the financial system

- In December 2015, we commissioned Brett Scott (the author of The Heretics' Guide to Global Finance) to prepare an overview of financial system reform efforts and innovations.
- In January 2016, we sent a short survey to the PRI Policy Committee, to a number of external experts, and to key staff within the PRI. One of the questions asked respondents to identify what they saw as the two to four key factors that are likely to change the shape, structure and function of the financial system.
- In January and February 2016, we conducted a review of the literature on drivers of change in the financial system. We identified the 2015 World Economic Forum (WEF) report, The Global Financial System: Policy Recommendations for the Future, as a key reference, because of its institutional importance, because of its relevance to our work and because it captured the majority of suggestions that had previously been made to us. This report identifies five major forces that are shaping the future financial system, namely the growth of emerging markets, technology, regulation following the global financial crisis, trust in the financial system and financial inclusion.
- We presented these five major forces to the PRI Board in February 2016, and to the SFS Advisory Group in February 2016 and April 2016. We received three pieces of feedback:
  - that the WEF proposals be used as the starting point for our list of driving forces;
  - that we add two drivers to the WEF list: demographic change and changes in pensions design;
  - that we take account of drivers and pressures external to the financial system (e.g. the impacts of environmental degradation on the financial system).

On the following page we present what we have identified as the seven most important drivers of change in the financial system, and how we intend to take account of drivers and pressures outside the financial system. In the PRI's formal consultation document, we invite feedback on whether these are the most important drivers of change in the financial system, including whether any should be added or removed.

In Section 6, we discuss how we are likely to use these in the selection of potential projects or interventions.

Drivers of change within the financial system

Key driver	Commentary and reflections
Demographic change	• Ageing populations (numbers of pensioners, increases in longevity) will affect the asset and liability profiles of pension funds and of public welfare systems. The specific impacts will depend on other public policy interventions (e.g. measures to encourage people to work beyond current retirement ages, measures to improve public health). • Future generations may have radically different views on, and expectations of, financial services, pensions and social/environmental issues.
Structural changes in the design of pensions	• There is a move away from defined benefit (DB) schemes to defined contribution (DC) schemes and to hybrid DB/DC schemes (e.g. target benefit schemes). • There is increasing use of personal pension plans, such as 401(k) schemes in the US, and of alternative savings vehicles (e.g. the recently announced Lifetime ISAs in the UK). • Roles and influence of pensions system actors (e.g. investment consultants, banks, investment managers) are changing.
The growth of emerging markets	• Emerging markets occupy an increasingly important role in the international financial system. By 2020, total financial assets on a global basis are estimated to approach US$900 trillion, a 50% increase from 2010, with developing economies accounting for approximately 25% of this total. • There are ongoing efforts to enable emerging markets financial services providers, corporates, public institutions and households to access a range of quality, affordable financial products and services, while also protecting customers from risks, enabling saving and investment and supporting the creation of jobs and enterprises through the efficient allocation of credit and capital.
Technology	• This includes alternative providers of capital, payment platforms and automated investment solutions. • Internet connectivity and digital technologies are redrawing how individuals, institutions and governments interact with one another, produce and consume products and services, and compete for resources, information and customers. • Historical cost paradigms, which served as barriers to entry, are eroding. • Traditional financial institutions no longer control the entire value chain. • Technology-enabled innovation may benefit underserved market segments as a result of improved distribution mechanisms, increased competition, decreased costs and the creation of novel financial products. A key driver of this transformation is expanding global smartphone ownership. • New entrants often fall outside the traditional domain of policy-making and regulation, raising questions such as: How sustainable will new business models and products be during times of economic stress? How do FinTech companies ensure appropriate customer data collection and usage practices? What are the related cyber-risks?

Key driver	Commentary and reflections
Regulation after the global financial crisis	• The global financial crisis exposed the consequences of a highly interconnected and complex global financial system. • There have been significant changes in regulatory and monetary policies (e.g. capital adequacy requirements, liquidity standards) directed at ensuring the safety and soundness of the financial system and supporting economic growth. • Systemically important institutions have been required to codify resolution plans in the event of liquidation. • Correspondent banking has been identified as an activity that is in retreat within private-sector financial services firms. This could adversely impact developing economies by cutting off a core channel to the international financial system.
Trust in the financial system	• Poorly designed incentive systems, insufficient risk disclosure, lax corporate governance, weak internal controls and illegal or unethical activities from some market participants were all root causes of the global financial crisis. • The financial sector performs indispensable functions such as enabling saving and investment, providing protection from risks and supporting the creation of new jobs and enterprises. It is critical that the sector provides these functions for society in a stable, sustainable way. • Criticisms of the financial system include: implicit subsidies for firms considered "too big to fail" that can allow financial institutions to enjoy privileged access to low-cost funding but protect creditors in the event of failure, the complex and often opaque interconnections that exist among large financial institutions and industry participants, poorly designed incentive systems, excessive leverage, insufficient liquidity, inadequate or unenforced fiduciary standards and the illegal or unethical activities of some market participants. • The finance industry has taken steps to change the way it does business. These steps, combined with regulatory changes, have contributed to reductions in leverage, increases in reserves and improved capital adequacy ratios. • Changes have been made to the level and structure of compensation and to business practices such as training, whistleblowing, sales and product approvals.
Financial inclusion	• More than 2 billion adults globally are unable, through limited access and lack of appropriate products to participate in the financial system. Financial inclusion is recognised as critical to poverty reduction and economic growth. • The digitisation of financial services, including savings, credit, payments, transactions and insurance, has significantly increased the number of financially included individuals over the past few years.

External to the financial system

The world that the financial system of the future will exist in will be shaped by geopolitical and other forces such as:

- environmental degradation (e.g. climate change);
- natural resource depletion;
- the erosion of multilateralism;
- the rise of nationalism;
- protectionism;
- systemic corruption;
- conflict.

While these may have limited direct impact on the financial system or on the actors, activities and relationships within the financial system, they will profoundly alter the context within which the financial system works. For example, conflict in a country or region may limit investors' willingness or ability to invest there, may limit the ability to provide banking, insurance or other financial services for local populations (e.g. for countries that face economic sanctions) and may affect these countries' ability to raise capital from the global capital markets.

Our approach to these and other wider geopolitical forces will be two-fold. First, we will monitor and track their evolution and assess the implications for the financial system. If they start to have a significant impact on the financial system, directly or indirectly, we will review whether they need to explicitly added to our list of drivers of change identified above. Secondly, we will analyse them as externalities to the financial system (see Section 4): we will look to analyse whether the financial system plays a causal role in the creation of these forces and/or might play a role in resolving them, or mitigating their negative impacts.

CRITERIA FOR SELECTING PROJECTS

The PRI's formal consultation document (Sustainable Financial System, Principles, Impact) provides a high-level overview of how the PRI will determine which projects to progress. It also comments on the conditions (or circumstances) under which the PRI is likely to be considered well-positioned to work in a particular area.

In this section, we present our current thinking on the criteria we will use to select interventions. We welcome feedback on these criteria and on the approach being proposed for the prioritisation and selection of projects.

The end point for this programme is the development of a robust and credible list of five to ten projects, project areas or interventions that will make a material contribution to a sustainable financial system. These would then be researched and analysed in detail, leading to an action plan directed at addressing the problem, issue or barrier identified. The PRI would then, on its own or in partnership with others, implement that action plan.

In Section 4, we listed 30 causal factors that we believe underlie the most significant risks and impacts associated with the financial system, and that are likely to be the priorities for action.

On the next page we discuss how that longlist of causal factors might be reduced to a more manageable list of between five and ten areas where the PRI should focus its attention, and how these might be prioritised. We welcome feedback on the general methodologies and on the specific criteria being proposed.

Canvassing views on the selection of projects

We discussed the prioritisation of issues and the selection of projects with the PRI Board in February 2016, and with the SFS Advisory Group in February and April 2016. We received the following feedback:

- that the number of project areas should be limited to between five and ten projects or interventions, and that these projects should be staggered over the lifetime of the PRI's Blueprint for responsible investment (i.e. over the next ten years);
- that the selection and prioritisation of project areas be based on credible and objective criteria, and on a robust process, allowing the PRI to revisit and update the analysis on a periodic basis, and to ensure that changes in underlying assumptions and conditions are captured;
- that the criteria for the selection of projects take account of PRI's capacities and capabilities to implement the projects.

Criteria for prioritising underlying causes

In order to prioritise the underlying conditions we apply the following criteria to each of the underlying causes identified in Section 4:

1. **Impact - Scale:** Does the underlying condition undermine one or more **desirable characteristics** (Section 3)? If a casual factor does not undermine one or more of the desirable characteristics, it is less likely to be seen as a priority.
2. **Impact - Future relevance:** Is it relevant to the possible future financial system, considering the **drivers of change** (Section 4)? If a causal factor is not relevant (or less relevant) to the financial system of the future, it is less likely to be seen as a priority.
3. **Scope:** Is **the PRI well-positioned to intervene** in this area? This would mean that most or all of the following apply:
   - There is a role for investors on the issue in question.
   - There is a role for the PRI and the PRI signatory base on the issue in question.
   - The PRI has the competence, capacities and capabilities it needs to make a meaningful contribution.
   - The PRI is not duplicating the work of others.

Our expectation is that we will use a semi-quantitative (e.g. a range of 0-5) framework for assessing projects against each of these criteria to produce a ranked (prioritised) list of causal factors. Further detail on how we will prioritise action appears int he following table.

Prioritising the interventions that the PRI should lead

For each causal factor, there are likely to be a series of projects or interventions that could be implemented that would go some way towards contributing to a sustainable financial system. The research and analysis of each causal area is likely to generate a list of potential projects or interventions. Without pre-empting this work, potential solutions could be in the areas of:

- investment practices;
- industry structures;
- policy and regulation;
- data and information;
- norms and culture;
- skills and knowledge;
- networks and communication channels.

These will then need to be prioritised. On the following page we set out the factors we will consider when selecting and prioritising projects. We welcome your views on whether there are other factors we should consider (or whether any of these factors are of lesser relevance) when selecting and prioritising projects.

Considerations	Comments
Impact – Scale	
What is the significance of the contribution that can be made?	This might be expressed as: "Will the intervention contribute to the characteristics of a sustainable financial system?" (See Section 3 for the list of characteristics).
Will the intervention have global relevance?	The PRI has a general preference for projects or interventions that are (a) relevant to international/cross-border institutions and organisations, (b) relevant to global regulatory frameworks, and/or (c) relevant to more than one country (or to multiple countries).
Will the intervention provide additional or knock-on benefits?	The analysis of projects and interventions will take account of wider impacts on the financial system. For example, it will seek to assess if action in one part of the system will create positive or negative impacts elsewhere in the financial system, or if an intervention will affect actors, relationships or activities other that those that are the direct subject of the intervention.
Impact – Future relevance	
Will the intervention be relevant to the financial system of the future?	We will use the drivers of change (see Section 5) to develop some qualitative descriptions of the financial system of the future. These are likely to be in the form of high-level statements about changes in the relevance or significance of individual actors, relationships, activities or impacts, with a particular focus on those actors, relationships, activities or impacts which are likely to be significantly more important or significantly less important in the future. We will use these high-level statements to test whether proposed projects or interventions are likely to be relevant to (or as relevant to) the financial system of the future.

Considerations	Comments
Scope - relevance to PRI	
Do the interventions fall within the scope of programme?	We define the broad scope of the PRI's work on a sustainable financial system as being: • What we have identified as the four key areas of risk and opportunity in the financial system, namely the relationship between owners and managers of capital, the delegated investment chain, the nature of the market place and externalities to the economy (see further Section 4). • What we have identified as the parts of the investment system that are closest to the PRI's membership and where the PRI is likely to have the most direct influence (see Section 3). This is the investment value chain which includes beneficiaries (e.g. savers, insurance policy holders); asset owners (e.g. pension funds, (re)insurers); investment managers, advisors and service providers (e.g. investment consultants, rating agencies, investment banks), companies and issuers, securities exchanges, and related regulators and regulations. Interventions that fall within these areas are more likely to be implemented. We are less likely to implement projects or interventions on those parts of the investment system that, while important to PRI's membership, are areas where PRI has less direct influence. Examples include macro prudential authorities (e.g. those responsible for wider monetary and economic policy settings) and the banking sector (including its role as a source of credit to companies). We are unlikely to implement projects or interventions that relate to retail financial advisors, banks as deposit-taking institutions, credit providers to individuals, retail financial regulation or regulators (with the exception of managed investment schemes).
Is the PRI well-positioned to intervene in this area?	This means that most or all of the following apply: • There is a representative role for investors on the issue in question. That is, investors can play a role in correcting or mitigating the causal factor or the symptoms that result. • There is a role for the PRI and the PRI signatory base. • The PRI has the competence, capacities and capabilities it needs to make a meaningful contribution. • The PRI can deliver the projects or interventions in question. The PRI now has a robust model for scaling up and delivering change projects on investment and policy. This can be summarised as: (a) perform research (using in-house expertise and/or external expert resources, in conjunction with relevant partners as appropriate), (b) build expertise (through the research process), (c) identify actions or interventions necessary to address the issues in question, (d) implement through raising resources, building implementation teams and building effective partnerships. • The intervention requires extensive consultation and dialogue with investors or other stakeholder groups. The PRI has an established track record of consultation with the investment industry and wider stakeholder groups on a variety of issues such as ESG capacity needs in the European institutional investment industry, policy and regulation (e.g. fiduciary duty, public policy submissions).

Considerations	Comments
Are other groups already working in the area?	Our intention is not to reinvent the wheel or duplicate the work of others. As part of the process of identifying and evaluating potential projects, we will analyse whether other groups are already active on the issue in question, and we will analyse the effectiveness of their interventions. In many cases, we are likely to conclude that there is limited role for the PRI, other than perhaps lending institutional support to these efforts. If we see that there is a role that PRI could play, we will engage with these groups to determine whether and how this support might be structured and how the needs and interests of these groups and the PRI might be aligned to deliver maximum value for all. We recognise that, in most cases, the PRI will not be able to deliver projects and interventions on its own. It will need to partner with other stakeholders (e.g. other investor networks, think tanks, industry stakeholders). We see working with others as an integral part of our strategy. We see that partnerships can enable us to address our weaknesses (e.g. in our knowledge, in our networks, in our capacities) and can help us to be more effective than working on our own. We also recognise that we can provide significant benefits to our partners, e.g. through the provision of expertise (e.g. on the structure and operation of the financial system), through our networks, through our ability to amplify and reinforce the agendas advanced by others.

MEASURING IMPACT

The PRI's formal consultation document (Sustainable Financial System, Principles, Impact) provides a high-level overview of how the PRI will measure its progress and impact. It also discusses the potential for the PRI to align its activities with the Sustainable Development Goals.

In this section, we present our current thinking on how we might measure our contribution to a sustainable financial system. This is ongoing work and we welcome feedback and suggestions on the ideas and proposals presented here.

Canvassing views on measuring impact

- We discussed the measurement of impacts with the PRI Board in February 2016, and with the SFS Advisory Group in February and April 2016. The consensus from these meetings was that we should look to explicitly measure our impact on the broader objectives of society and that the Sustainable Development Goals are a particularly important articulation of these broader objectives.
- We have had a number of discussions with Steve Lydenberg and William Burckart of The Investment Integration Project, which encourages financial professionals to consider the impacts of their investment decisions on wider environmental, societal and financial systems. One of the key elements of The Investment Integration Project's work is to develop a measurement framework that links stock and portfolio decisions to wider environmental, societal and financial systems.
- We partnered with ShareAction to ask signatories for their views on the relevance of the SDGs to their investment activities[4].
- We have reviewed a series of reports that discuss how the wider social, environmental and economic effects of investment activity may be measured[5].
- We are working closely with Nick Robins and Simon Zadek of the UNEP Inquiry on developing measurement frameworks for our activities.

While our thinking on the measurement of impact is at a relatively early stage, we do have some initial thoughts on how such measurement might be structured.

4 ShareAction (2016), Transforming our World Through Investment: An Introductory Study of Institutional Investors' Role in Supporting the Sustainable Development Goals (ShareAction, London), http://shareaction.org/wp-content/uploads/2016/03/TransformingOurWorld.pdf

5 Among the recent reports we have reviewed are:

- Lydenberg, S. (2015), Portfolios and Systemic Framework Integration: Towards a Theory and Practice. Exposure Draft (16 November 2015) (The Investment Integration Project), http://www.investmentintegrationproject.com/s/TIIP_Portfolios-and-Systemic-Framework-Integration_Exposure-Draft.pdf
- Lydenberg, S. (unpublished draft, 2016), Consideration of Environmental, Societal and Financial Systems in Investment: Principles and Pathways to Action. 5 May 2016 (The Investment Integration Project).
- University of Cambridge Institute for Sustainability Leadership (CISL) (2016), In Search of Impact: Measuring the Full Value of Capital (Cambridge Institute for Sustainability Leadership, Cambridge), http://www.cisl.cam.ac.uk/publications/publication-pdfs/impact-report.pdf

1. We should look to measure the impact of both individual interventions and the cumulative impact of all our interventions.

2. We should look to measure our impact in three areas:
   - inputs (i.e. the resources we and others deploy);
   - outputs (i.e. the actions we take, the activities we conduct, the materials that we produce);
   - impacts (i.e. the contribution that our activities make to a sustainable financial system, covering financial and non-financial aspects, and including impacts within and external to the financial system).

3. We should, to the extent possible, use the Sustainable Development Goals (SDGs) as a basis for tracking the impact of investor activities in support of a sustainable global financial system. The reasons are:
   - The SDGs constitute the most definitive and recent plan for sustainable development.
   - They are the most democratically tested scope of sustainable development, supported by governments and their citizens through extensive consultation.
   - By virtue of government and private sector work towards the 2030 development agenda, the SDG's will shape investment risk and opportunity, and therefore the sustainability of the global financial system, over time.
   - The SDGs allow us to consider the needs and interests of emerging markets as well as developed markets in our decisions on priority issues and priority geographies for action.
   - As the UN-backed organisation for responsible investment, the PRI has a responsibility to examine how it can fulfil the expectations in the SDGs and integrate them into investment activity.

4. More generally, we should develop indicators and measures for issues and impacts that:
   - are generally agreed to be the most important issues (a proxy measure for this could be the existence of international agreements (e.g. treaties, statements by recognised international bodies) on the issue in question);
   - can affect or have the potential to be affected by the operation of the financial system;
   - affect the resilience and stability of the financial system, or the ability of the system to absorb and adapt to exogenous shocks[6];
   - have significant impacts on society, on the environment or the economy.

5. We should be forward-looking in our choice of indicators. We should focus, as far as practicable, on areas where relevant and relatively clear targets have been developed and agreed by the international community. For example, Sustainable Development Goal 13 references the international climate process conducted within the United Nations Framework Convention on Climate Change, and recognises the work that has been carried out by the Intergovernmental Panel on Climate Change and by the International Energy Agency.

6. We should develop a measurement framework that links (a) corporate or issuer practice and performance, (b) investor practice and performance (ideally using the information reported to annual PRI signatory survey as the basis for this), and (c) wider measures of ecosystem or societal health and wellbeing.

In its 2015 report The Financial System We Need, the UNEP Inquiry highlighted the need to develop a performance framework to measure progress. The performance framework would track the efficiency, effectiveness and resilience of the financial system in the transition to sustainable development. Building on this, the UNEP Inquiry is developing a first framework of indicators across key sectors such as banking, insurance, capital markets and investment. The focus would be on performance at the overall system level to enable cross-country comparison. This performance framework will be published in October 2015 and will highlight key metrics, key data sources and where further work is needed.

6 We thank Steve Lydenberg for this point.

GOVERNANCE

Introduction

The PRI's work to prepare this programme was overseen by the PRI Board. The Board discussed the Sustainable Financial System work in July, September and December 2015 and February and May 2016.

The PRI Executive developed the content of the programme, supported by the Sustainable Financial System Advisory Group, which included past PRI Board members, chaired by Martin Skancke, PRI's current Chair. The PRI Policy Committee also provided input.

The SFS Advisory Group contributed to the programme through two preparatory papers, called the SFS White Paper and the SFS Plan, and three meetings, including a half-day, in-person meeting in New York on 14 April 2016. The SFS will meet again to review feedback to the consultation document and provide input on the prioritisation of areas for future PRI work.

Members of the Sustainable Financial System Advisory Group

The SFS is made up of past PRI Board members plus the PRI Chair, the Chair of the PRI's Policy Advisory Committee and the PRI Managing Director (ex-officio). The PRI Executive sincerely thanks the SFS members for their contribution to this work.

- David Atkin, CEO cbus, Australia
- Masaru Arai, Chair Japan Sustainable Investment Forum (JSIF), Japan
- Else Bos, CEO PGGM, Netherlands
- Melissa Brown, Daobridge Capital, Hong Kong
- Ann Byrne, Trustee Director, LUCRF Super, Australia
- Paul Clements Hunt, CEO Blended Capital Group, UK
- Georg Kell, Vice Chair Arabesque Asset Management, UK
- Mike Musuraca, Managing Director, Blue Wolf Capital, US
- John Oliphant, Managing Director, GAIA Infrastructure, South Africa
- Gavin Power, Deputy Executive Director, UN Global Compact
- Glen Saunders, Chair, Sustainalytics, NZ
- Daniel Simard, Director General, Bâtirente, Canada
- Bryan Thomson, PRI Policy Advisory Committee Chair; BCIMC, Canada
- David Russell, USS Investment Management, UK
- Martin Skancke, Chair, PRI
- Eric Usher, Head of UNEP Finance Initiative
- Fiona Reynolds, Managin Director. PRI (Ex-officio member)

PRI Executive Team

The PRI Executive team leading the development of this work were:

- Nathan Fabian, Director of Policy and Research
- Rory Sullivan, Consultant

RESEARCH AND ANALYSIS PROCESS

The material presented in the PRI's formal consultation document (Sustainable Financial System, Principles, Impact) and in this supplementary document is based on work conducted by the PRI Executive in the period August 2015 to May 2015. Each step has been discussed in detail and reviewed closely by key internal stakeholders (in particular the PRI Board, the SFS Advisory Group, the PRI Policy Advisory Committee and PRI staff). We have also sought external feedback on various elements of this work and have commissioned some research to support our work.

The Table below summarises the formal inputs and review processes that have informed this report.

Date	Who	Purpose	Comments
7 September 2015	PRI Board	To approve the priorities for the PRI's Policy and Research work stream.	This work formed part of the PRI's 2015-18 Strategic Plan. The PRI Board agreed to establish the PRI's work programme to improve the sustainability of the financial system The PRI Board also agreed to establish the Sustainable Financial System Advisory Group (the 'SFS') (see, further Section 8).
3 December 2015	PRI Board	To approve the Terms of Reference for the SFS Advisory Group	See Section 8.
October 2015 to January 2016	PRI Executive staff	To develop a comprehensive list of risks and sustainability challenges.	A consolidated list is presented in Section 4.
November 2015 to February 2016	PRI Executive staff	To develop a comprehensive list of projects and interventions that PRI could implement. To ensure that the PRI's work complements that of key international organisations (and potential partners) such as the OECD, UNEPFI, the UNEP Inquiry into the Design of a Sustainable Financial System and the World Economic Forum.	See Sustainable Financial System Literature Review

Date	Who	Purpose	Comments
January 2016	PRI Policy Committee Selected external experts Key PRI staff	To get feedback on the characteristics of a sustainable financial system, on the scope of the PRI's activities in this area, and on the key drivers of change in the financial system.	In January 2016, we sent a short survey to the PRI Policy Committee, to a number of external experts, and to key staff within PRI. The respondents were asked to: • Identify what they saw as the two to four key factors that are likely to change the shape, structure and function of the financial system (see Section 5). • Suggest three to five key characteristics of a sustainable financial system (see Section 3). • Comment on the proposed scope of the financial system for the purposes of the PRI's work on a sustainable financial system (see Section 3).
January 2016	Brett Scott	To identify emerging, disruptive trends in the financial system	We commissioned Brett Scott (the author of The Heretics' Guide to Global Finance) to prepare an overview of financial system reform efforts and innovations. This report was an input to the drivers of change (see Section 5).
9 February 2016	SFS Advisory Group	To obtain feedback to the work to date	The SFS provided comment on the scope, characteristics (see Section 3), drivers of change (Section 5) and the criteria that should be used to prioritise projects and interventions (Section 6).
25 February 2016	PRI Board	To obtain feedback to the work to date	The Board commented on the scope, characteristics (see Section 3), drivers of change (Section 5) and the criteria that should be used to prioritise projects and interventions (Section 6).

Date	Who	Purpose	Comments
March 2016	ShareAction	To obtain feedback from signatories on the relevance of the SDGs to their investment activities	We partnered with ShareAction to ask signatories for their views on the relevance of the SDGs to their investment activities . The report concluded that there is broad support for using the SDGs as a framework to guide the PRI's work on a sustainable financial system. The report also provided examples of investors using the SDGs to guide their investment activities.
10 March 2016	UNEPFI/UNPRI Policy dialogue	To gather feedback on the programme	Feedback received on the framing of the programme and experience of past projects to align the financial system with sustainable economic development.
14 March 2016	PRI Executive staff	To critique the programme for weaknesses and improvement opportunities	
14 April 2016	SFS Advisory Group	To obtain feedback to the work to date	The SFS provided comments on the scope, characteristics (see Section 3), drivers of change (see Section 5, in particular the discussion of drivers of change from outside the financial system) and the criteria that should be used to prioritise projects and interventions (Section 6). The SFS also made proposals on how the long list of risks could be organised into underlying causes and consequences (see Section 4).
19 May 2016	PRI Board	To review and approve materials for public consultation	

7 ShareAction (2016), Transforming our World Through Investment: An Introductory Study of Institutional Investors' Role in Supporting the Sustainable Development Goals (ShareAction, London), http://shareaction.org/wp-content/uploads/2016/03/TransformingOurWorld.pdf

Credits

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The Principles for Responsible Investment (PRI) Initiative

The PRI Initiative is a UN-supported international network of investors working together to put the six Principles for Responsible Investment into practice. Its goal is to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision making and ownership practices. In implementing the Principles, signatories contribute to the development of a more sustainable global financial system.

The Principles are voluntary and aspirational. They offer a menu of possible actions for incorporating ESG issues into investment practices across asset classes. Responsible investment is a process that must be tailored to fit each organisation's investment strategy, approach and resources. The Principles are designed to be compatible with the investment styles of large, diversified, institutional investors that operate within a traditional fiduciary framework.

The PRI Initiative has quickly become the leading global network for investors to publicly demonstrate their commitment to responsible investment, to collaborate and learn with their peers about the financial and investment implications of ESG issues, and to incorporate these factors into their investment decision making and ownership practices.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with
UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP FINANCE INITIATIVE

UN Global Compact

Launched in 2000, the United Nations Global Compact is both a policy platform and practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org

United Nations Global Compact