Financial and Professional Services

Trade challenges and opportunities post pandemic

RESEARCHED AND WRITTEN BY
The Economist INTELLIGENCE UNIT

Foreword

The financial services sector plays a vital role in the UK economy, contributing almost 7% of the UK's total economic output and employing over a million people across the country. In 2018, the professional services sector contributed £75bn (US$104bn) to the UK economy. The sector grew by more than 7% in 2019-20. Despite the unprecedented shock to the global economy from the Covid-19 crisis, the professional services sector remained largely resilient, providing liquidity and services throughout the pandemic. The UK Government and regulators worked closely with the sector to keep branches and offices open, and offering payment holidays and loans to individuals and businesses.

The financial and professional services sector underpins the global financial system and the global economy more broadly. It enables financing of vital services and infrastructure and supports economic growth and prosperity. However, accelerated digital transformation, regulatory pressures, and rapidly changing customer preferences are challenging existing business models in financial and related services, with wide-ranging implications for the future of the sector.

The sector is also an important source and enabler of innovation, particularly digital transformation. The UK is home to one of the most vibrant financial technology (fintech) sectors in the world, with around 2,500 companies providing innovative digital solutions in a wide range of segments. These include insuretech, lawtech, regtech, lending, payments, wealthtech and financial infrastructure. Digital payment platforms are becoming essential for financial inclusion. The UK Government, alongside the Bank of England, is a world leader in working towards a Central Bank Digital Currency (CBDC).

A healthy and open financial and professional services sector will also play a vital role in addressing climate change. The urgent transition to a climate-resilient economy requires mobilisation of investment and green finance on an unprecedented scale. The UK has been a global leader in these efforts as chair of the 26th UN Climate Change Conference (COP26), requiring environmental disclosures from key financial services businesses and developing international standards to support global cross-border markets.

To take full advantage of the opportunities ahead–whether that is addressing technological disruption, meeting the challenge of climate change, or providing a rapid and equitable post-pandemic recovery and long-term economic growth–the world needs to transition towards innovative, green and open financial and professional services. The UK Government will continue to support the financial and professional services sector by fostering innovation and competition on a global stage, providing opportunities for communities, creating jobs, supporting businesses, and powering growth across the UK.

Andrew Mitchell
Director General
Exports and UK Trade
Department for International Trade (DIT)

About this report

Trade challenges and opportunities in the post-pandemic world: Financial and professional services is an Economist Intelligence Unit (EIU) report, supported by **the UK's Department for International Trade (DIT).**

Through a range of expert interviews, secondary literature review and a data audit, this report explores the challenges and opportunities for global trade and investment in creative goods and services. The EIU would like to thank all experts for their time and insights.

Nathan Stovall, Principal Analyst, S&P Global Market Intelligence

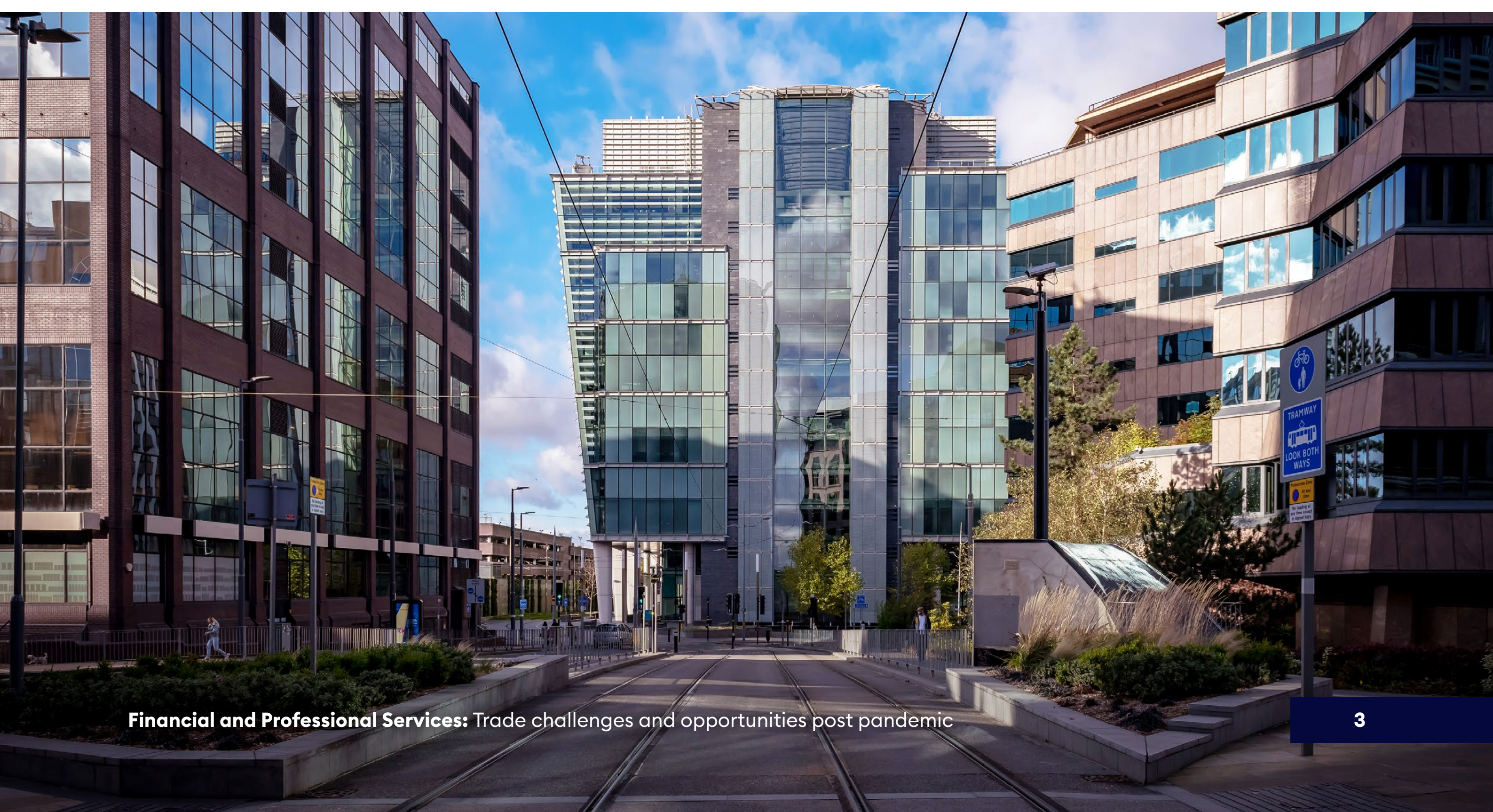
Janine Hirt, Chief Executive, Innovate Finance

Scott Devine, Head of Legal and Professional Services, TheCityUK

Nathan Fabian, Chief Responsible Investment Officer, Principles for Responsible Investment (PRI)

Nick Robins, Professor in Practice, Sustainable Finance, Grantham Research Institute on Climate Change and the Environment

Matus Samel is the EIU's project lead and editor, **Jeff Salway** is the author, and **Julian von Moltke** the research assistant.



Section 01

Financial and professional services in global trade

01

Financial and professional services in global trade

It's no exaggeration to state that global trade and the modern economy are heavily reliant on a functioning financial sector and related professional services.

The global financial services industry underpins transactions, drives growth, provides financial stability, holds savings and finances vital services and infrastructure, among many other crucial roles. Similarly, the global professional services industry provides essential specialised knowledge in areas that are essential for the functioning of modern businesses, such as law, accounting, consulting, or marketing. The financial services industry is a complex and dynamic sector providing services, such as insurance, retail banking, corporate and commercial banking, investment banking, payments, and wealth and asset management. Crucially, these products and services, alongside their related professional services, are constantly evolving, adapting to and fuelling transformation across the economy, particularly through financial and technological innovation, including financial technology (fintech).

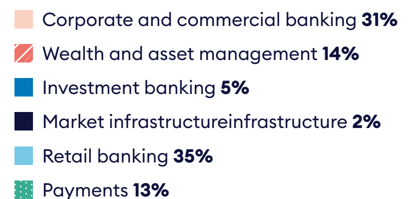
The state of play

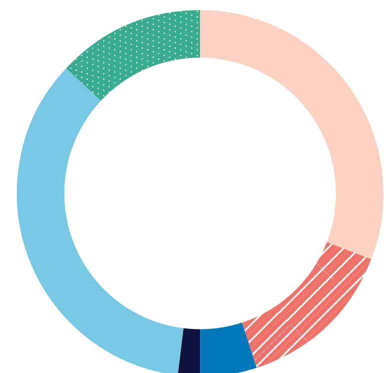
The Covid-19 pandemic significantly disrupted an industry that was already being reshaped by the effects of the global financial crisis and major themes including sustainability and digital innovation. Global debt levels have increased in recent years and hit a record high of US$281trn at the end of 2020.[1] The new peak reflected a surge in borrowing by governments, businesses and households seeking to navigate the Covid-19 landscape. Debt levels are expected to continue increasing through to the end of 2021, reflecting ongoing pandemic-related pressures and Central Bank stimuli.

The industry arguably entered the pandemic more resilient than it had been prior to the global financial crisis, reflecting a series of reforms and some important shifts over that period.

Global revenues from financial intermediation had reached an estimated US$5.5trn by 2019, with retail banking accounting for 35% of those revenues and corporate and commercial banking accounting for 31%. A further 14% came from wealth and asset management and 5% from investment banking.[2]

Figure 1: Retain and commercial banking at the top: *Global banking revenues in 2019, by segments (% share)*





Source: McKinsey & Company, 2020

Global trade in financial services has traditionally occurred through firms establishing a commercial presence in different markets.

In the insurance component of the industry, growth in 2019 saw global premiums approach the US$5trn mark, generated by revenues from life insurance (45%), property and casualty insurance (31%), and health insurance (26%). Around 70% of total premium growth from 2010 to 2019 came from North America and the developing Asia-Pacific region, with the latter accounting for about 36% of premium growth between 2015 and 2018.[3]

Global trade in financial services has traditionally occurred through firms establishing a commercial presence in different markets. But while most financial trade is still domestic, the international market is growing. Gross exports of financial services were estimated at around US$646bn in 2018, although just three countries (the US, UK and Luxembourg) accounted for half of that.[4] Trade flows in financial services will inevitably be disrupted to some extent by the pandemic and its aftermath. The implications of the crisis vary between different areas of financial services. While deposits surged as spending fell, for example, there were pressure points for lenders as households and businesses sought new credit lines, while interest rate cuts led to a compression in interest margins.

Breaking it down

The fortunes of banks will be tied to the pace at which the global economy recovers from the crisis. "There's an old line in banking, that banks are thermometers for their local economies," observes Nathan Stovall, principal analyst at S&P Global Market Intelligence. "If you're in a market with tailwinds it means you have the opportunity to grow, invest and innovate. If you're in a market facing headwinds the focus is on efficiencies and cutting costs and less on expansion."

For banks, the ramifications of the pandemic will be seen firstly in the form of credit losses, with defaults expected to soar as state support is withdrawn, and then in the shape of low revenues as the global economy struggles to recover.

According to one estimate, some US$3.7trn in revenue will be lost over the next five years as a result of the Covid-19 crisis.

In the US, the expectation is that losses and defaults will be lower than in 2020, which itself wasn't as bad as initially feared, due to the effect of government and Federal Reserve support.

"Whether or not the deficit is an issue, in near term it's way better than anyone expected, and banks have reserves," says Stovall. Indeed, interim reports for 2021 for some of the key players reflect these expectations, showing positive signs towards recovery.[5]

The uneven nature of that recovery will hit some regions and sectors harder than others, however. There is limited scope for wider margins in developed markets, with interest rates low and most people already using financial services. In developing economies, the immediate impact of the pandemic will be greater, with credit risks elevated, but there is also much greater scope to reach new individual and business customers.[6]

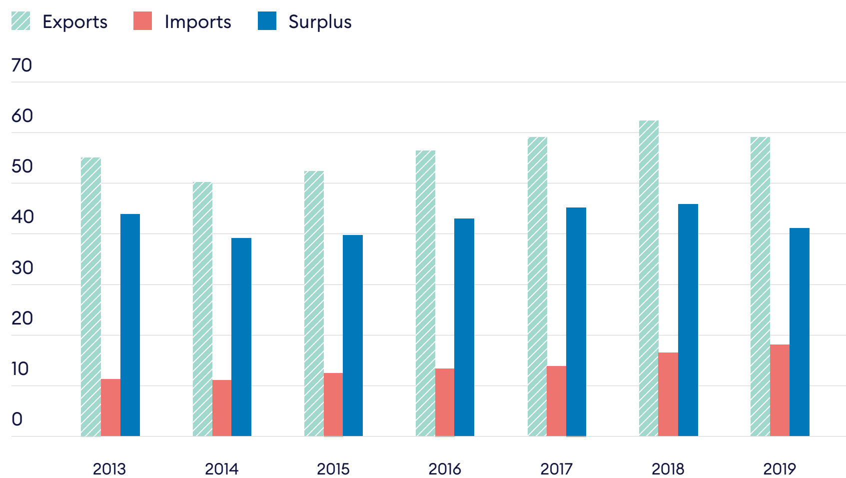
Insurers are similarly dependent on the ability of the global economy to bounce back quickly, although some product lines have already suffered as customers cut back on coverage perceived as non-essential. The insurance sector dynamic differs to that of banking in that the bulk of revenues are derived from developed world markets. However, the pandemic may contribute to increased demand in some emerging markets, particularly those offering little state-backed protection and where insurers can bridge the gap for the growing consumer classes.[7]

For professional services firms, such as accountants and lawyers, the pandemic was challenging in a more positive sense. Law firms reported increased demand for legal and corporate advice (with businesses looking to restructure, deal with bankruptcy and navigate private equity deals).[8] In accountancy, the big four – Deloitte, EY, PwC and KPMG – saw fees increase by US$2.2bn to a combined US$157bn, with three of the four reporting growth for 2020.[9]

UK perspective: Remaining resilient in challenging times

Contributing almost 7% of the UK's total economic output and employing over a million people, the financial services sector plays a huge role in the UK economy. Just over a third of the UK's financial services exports went to the EU in 2019, with another 30% to the US and 16% to Asia. The trade surplus in 2019 was £41bn, with exports of £59n and imports worth £18bn.[10] The professional services sector, which performs a crucial role for UK financial services, contributed £75bn to the UK's economy in 2018 and posted growth rates of 7% and over in 2019-20.[11]

Figure 2: Surplus generator: *UK trade in financial services (£bn) 2013-19*



Source: House of Commons Library, 2021

All of that was before the combined effects of the Covid-19 pandemic and the country's departure from the EU. However, the industry remained largely resilient even as the Covid-19 outbreak brought economic activity to a virtual standstill, due partly to the ability of most staff to work from home, significant investment into adoption of advanced technologies, as well as higher uptake of digital solutions by customers.[12] UK financial services posted year-on-year export growth of 9.3% in the first half of 2020, with a relatively modest decline in the second quarter.[13] Output in the sector was just 3% below pre-pandemic levels in November 2020.[14]

The true effect of the pandemic on the sector will become clearer in time, particularly as defaults rise in the wake of state support being reduced. The Financial Conduct Authority (FCA) warned in early 2021 that around 4,000 UK financial services firms were at "heightened risk of failure" due to the impact of the Covid-19 pandemic.[15]

The industry remained largely resilient even as the Covid-19 outbreak brought economic activity to a virtual standstill.

One area with significant growth potential that has received significant attention from investors, policy makers and regulators alike is fintech.

Financial services exports had already been impacted by Brexit, as firms moved some people and capital out of the UK and into EU financial centres in the years leading up to the UK's exit from the union.[16] Imports of UK financial services by the EU declined by £600m in the first quarter of 2021, compared with the first quarter of 2019, with reductions concentrated in France, Ireland and the Netherlands, despite a slight offset caused by an increase in imports in Germany and Switzerland.[17] However, the scale of the relocation has been relatively limited so far. According to one survey, since 2016, relocations of financial sector jobs rose to nearly 7,600 in January 2021, with 43% of firms in the survey indicating they had moved or planned to move some UK jobs to Europe.[18] A shift towards non-EU countries also continues. Although the US remains the UK's largest non-EU trading partner for imports of financial services, both Singapore and South Korea increased their share among importers of UK financial services in the first quarter of 2021.[19]

One area with significant growth potential (see UK perspective: Digital opportunities box) that has received significant attention from investors, policy makers and regulators alike is fintech. The UK Government-commissioned Kalifa review of UK Fintech outlines a far-reaching plan with key recommendations for protecting and further developing the global competitiveness of the country's fintech sector, including establishing a Fintech Growth Fund, providing early-stage fintech investment support, amending the UK's initial public offering (IPO) listing regime, as well as providing support for developing and attracting domestic and international talent.

Section 02

The digital imperative

02

Sub-sectors driving broader digital revolution

The impact on financial services propositions and market competition has already been significant, and it's likely to become a bigger influence on financial stability and the regulation of the sector.

In the early years of the last decade the biggest force shaping the financial services industry was the post-crisis overhaul.

But in recent years the main source of change has been technological, from the emergence of financial technology (fintech) and insurtech to the influences of blockchain and artificial intelligence (AI).

Digital technologies are restructuring how financial services are provided, who provides them, the competition dynamics in the market and how customers interact with the industry. Fintech in particular is disrupting business models in financial services, with wide-ranging implications for the future shape of the sector.

Fintech and transformation

Traditional providers of financial services no longer have the market to themselves.

Challengers including neobanks (digital-only providers), ecommerce providers and telecom providers are gradually increasing their share of the market, both in terms of the underlying processes and the services offered to retail customers.

Much of this activity sits within the fintech sector, housing companies from niche start-ups to established global technology providers. The impact on financial services propositions and market competition has already been significant, and it's likely to become a bigger influence on financial stability and the regulation of the sector. "Fintech is becoming increasingly integrated into sectors and industries beyond tech companies, banking incumbents and traditional financial services institutions," says Janine Hirt, chief executive of Innovate Finance.

"Embedded finance is now mainstream in terms of payments, with businesses like transport firms or food delivery companies now giving their customers access to financial services and payments, often in an invisible and seamless way. "Fintech is most visible in retail banking, where platforms allow consumers to open bank accounts online or take part in peer-to-peer lending (or crowdfunding), payments (with online and mobile payments soaring during the pandemic) and wealth and asset management, where firms are providing automated investment and advice services.[20]

Traditional providers that struggle to shift activities to digital channels risk being left behind by those able to transition successfully and reach new customers. In 2018, fintech lenders already accounted for 38% of unsecured personal lending in the US, while they are "economically relevant in the financing of small and medium enterprises (SMEs) in China, the US and UK",[21] according to the Bank for International Settlements (BIS).

Those trends accelerated with the Covid-19 outbreak. In the UK, for example, it was estimated that during the pandemic some six million adults downloaded an online banking app for the first time. Two-thirds of first-time users said they would try other types of digital payments, with 84% reporting that they found banking apps easier to use than expected.[22]

The move to digital channels certainly benefited neobanks and increased consumer comfort with the idea of a banking relationship that didn't need a physical branch."

Nathan Stovall, Principal Analyst, S&P Global Market Intelligence

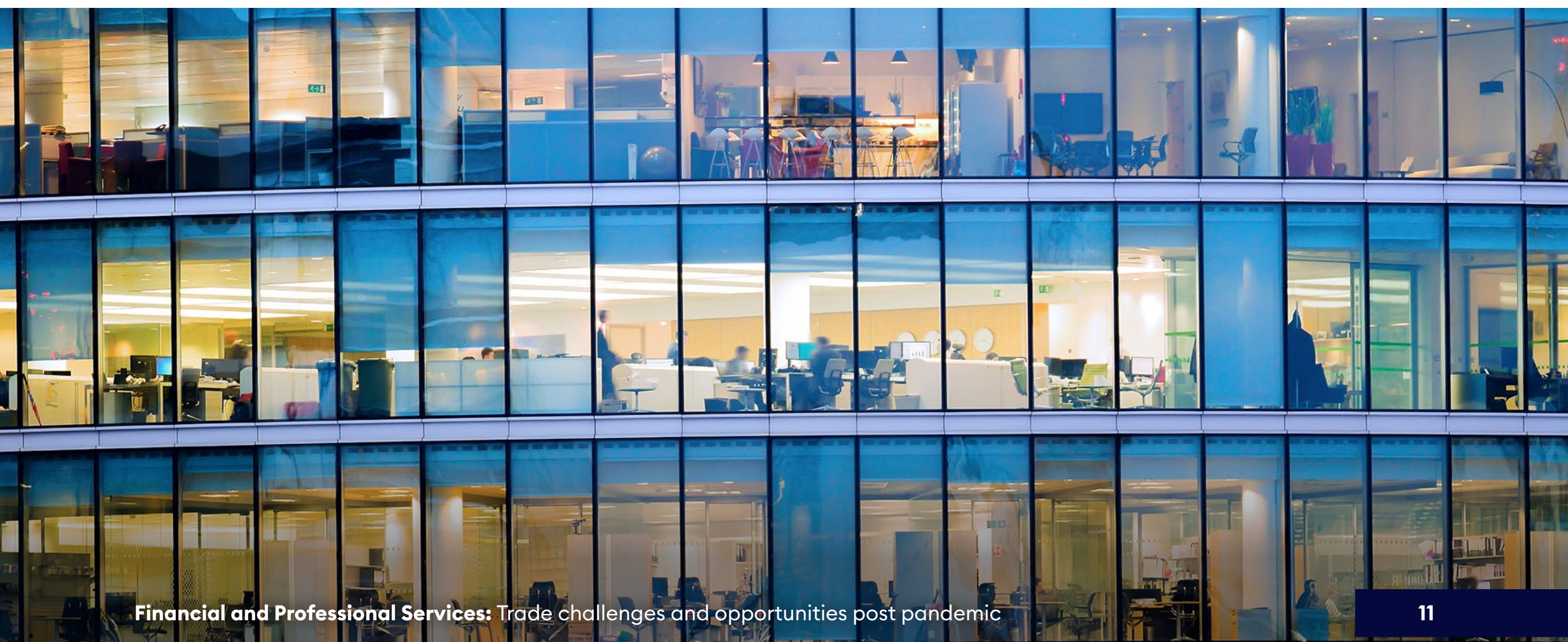
According to Mark Carney, former Governor of the Bank of England, the true promise of fintech (and the new entrants driving it) lies in its potential to "unbundle banking into its core functions of settling payments, performing maturity transformation, sharing risk and allocating capital". In other words, tech allows firms to move away from a model in which current accounts ('free' or otherwise) act as a hub for the provision of other financial products.

"The move to digital channels certainly benefited neobanks and increased consumer comfort with the idea of a banking relationship that didn't need a physical branch," says Stovall. Fintechs are now expanding their services and becoming less specialist. In the UK, for instance, P2P specialist Zopa launched savings and credit card products after being granted a full-banking licence in summer 2020.[23] Similarly, Revolut, which started out by offering a travel-focused prepaid debit card, now offers services including business payments and stock trading and applied for a full UK banking licence in early 2021.[24]

The shift partly reflects the impact of the pandemic on digital lenders that didn't have the deposit funding to support their lending. "Not having the stable funding was always the argument against them," says Stovall. "We've seen them trying to become more bank-like and that's accelerated." As the sector matures, the influence of global technology platforms will grow. The likes of Google, Amazon, Facebook, Apple and Tencent are launching payment services, investing in fintechs and partnering with banks to establish a competitive foothold in the industry.[25]

Payments in particular is a logical market for the big tech entrants, according to Stovall. The payments processing sector already boasts some of the biggest and most valuable fintech firms, including Square (US), the UK's TransferWise and Sweden's Klarna. "It's a natural extension of the customer relationships they have. In the US, you have banking relationships that go back generations, but payments isn't a place where that is such a barrier."

Consumer expectations and demand are consequently shifting in line with the greater ability for people to access their finances on their own terms, when and where they choose. "This is also true for the asset management and insurance industries, as new entrants and technologies are helping to provide consumers with simple and seamless ways to control their finances," says Hirt. "Consumers had already begun to adjust their expectations around payments, and this shift has been further accelerated by the pandemic." Contactless payments are clearly here to stay, and consumers increasingly demand the seamless cross-industry experience that embedded finance provides. "It is likely that omnichannel payment processing options will also increase and expand, while we believe open banking, and open finance more broadly, will remain a key driver of payments transformation," says Hirt.



Central Bank Digital Currencies (CBDCs)

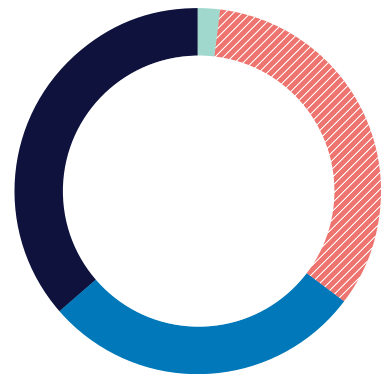
Digital currencies are becoming a focus of attention in central banks around the world amid growing government, business and consumer interest in its possibilities. As it stands, the major central banks issue money in the physical form of banknotes, which businesses and households can use for payments. While they do also provide electronic money, this is purely for banks and certain financial institutions.

However, a Central Bank Digital Currency (CBDC) would allow central banks to make electronic money available to all households and businesses, allowing them to make electronic payments in central bank money. "Centralised digital currencies are an exciting innovation, and their introduction would bolster the UK's financial stability, providing individuals and businesses with access to money in digital form, and creating a more efficient and resilient payments system," says Hirt at Innovate Finance.

The Bank for International Settlements reported in June 2021 that 28% of the 50 central banks it surveyed were looking to make CBDCs interoperable by forming multi-CBDC arrangements (where different CBDCs could be linked or even integrate into a single payments system).[26] Of the major economies, China is thought to be the most advanced in its testing, with the e-CNY digital yuan expected to launch in 2022.[27]

Figure 3: Going digital: *Willingness of central Banks to adopt range of approaches to interoperabilty of Central Bank Digital Currency (CBDCs) (%), 2021*

No **2%**
Not yet, but potentially later **33%**
Yes **28%**
Undecided **36%**



Source: Bank for International Settlements, 2021

There are several significant implications of CBDC development. One advantage is that because central banks cannot default, it would be a less risky way of holding money. They could also bring wider access, and stronger governance and privacy standards to digital payment systems, currently dominated by cryptocurrencies such as Bitcoin.

From the central bank perspective, it could have an impact on liquidity, with fewer deposits relative to loans.[28] At the same time, it would further add to the central bank's role in the economy, as by removing deposits from the private banking system it would affect the level of funding available to banks.[29]

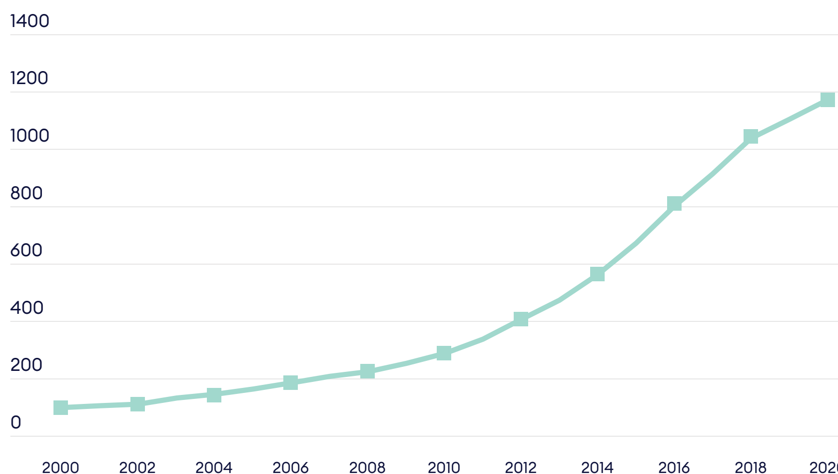
When it comes to central bank monetary policy, the ability to charge negative interest rates on CBDC accounts (assuming paper currency had been eliminated) would make it easier for banks to tolerate negative interest rates and reduce rates to tackle deflation.[30] One effect of this would be to offset the loss of control resulting from the growing influence that fintechs and big tech companies have on financial flows. "CBDCs could take market share away from traditional card providers and maybe payments companies," according to Stovall.

"It could be disruptive for banks as well, as people could decide they don't need a banking relationship because they have other means of transactions." It's early days, with the extent of central bank adoption of digital currencies far from clear. "But if we see central banks grow out digital currencies, it does increase the likelihood that digital currencies will become more common as transactions."

UK Perspective: Digital opportunities

Fintech is at the centre of digital transformation in the UK financial services sector. There are around 2,500 fintech firms in the UK, with a 21% year-on-year growth in their number between 2011 and 2016, according to Deloitte. They are spread across an increasingly wide range of segments, including insurtech, regtech, lending, payments, wealthtech and financial infrastructure.[31]

Figure 4: Fintech boom: *Number of UK Fintech companies (rebased at year 2000), 2000-2020*



Source: Deloitte, 2020

The effects of the pandemic on the different segments varied. While some business models suffered, such as the peer-to-peer lenders that saw government-backed finance initiatives reduce SME demand for alternative borrowing sources, those focused on ecommerce and payments benefited from the sharp increase in consumer adoption of digital channels.[32]

"Alternative lenders were initially struck hard, as very few fintechs were accredited to distribute government loans to small businesses, or access wholesale funding on the same terms as banks," Hirt explains. Eventually, however, more alternative non-bank lenders were given accreditation and were able to support SMEs through the crisis, she adds. "Funding Circle, for example, distributed more than a third of all Coronavirus Business Interruption Loan Scheme (CBILS) loans." Meanwhile, neobanks such as Starling and Revolut benefited as more people turned to digital banking, and fintechs offering salary advances saw high demand, particularly from those hardest hit by the pandemic.

With financial fraud and scam cases growing, fintechs operating in the regulation and compliance space have also come to the fore, according to Hirt. "Harnessing the power of machine learning and AI to identify and notify suspicious transactions or behaviour patterns as quickly as possible is now a must-have, not a nice-to-have, and the need for innovation in this space will help fintechs working in this sector grow."

Digital payment platforms are also seen as vital in addressing a financial inclusion issue accentuated by the effects of the Covid-19 pandemic. A number of UK fintechs are building strategic partnerships with financial institutions, governments and other organisations to distribute funds to those outside the banking system. When the pandemic broke out, for example, a group of UK fintechs, including Fronted, Credit Kudos, and 11:FS created a Covid Credit platform that used open banking data to help the self-employed prove their incomes had been impacted.

Financing bounced back strongly in 2021, according to Innovate Finance, which revealed that UK fintech raised $5.7bn in the first half of the year, outstripping the total for 2020 by 34% and breaking the annual record set in 2019 by 26%. "Whilst there was an initial dip in investment last year when the pandemic first hit, investor confidence in fintech has remained high, especially with many innovative fintech companies providing solutions to problems created by lockdown," according to Hirt.

Digital and AI technologies are lowering costs, bringing previously exclusive services with reach of a much wider customer base."

Scott Devine, Head of Legal and Professional Services, TheCityUK

Professional services

While the influence of digital technologies on the professional services industries isn't new, the process has accelerated over the past couple of years. In accountancy, for example, automation might be seen as a threat to traditional approaches. But the evolution of AI and digital data provides opportunities for accountants to widen their influence in a more strategic and advisory sense, using their insights to inform the future shape of an organisation.

Over in the legal sector, lawtech covers a growing range of processes and technologies, such as predictive AI (i.e. tools that predict outcomes based on case law), advanced chatbots, blockchain-supported smart legal contracts and document automation. "Firms are increasingly investing in these technologies to ensure more efficient management of routine work and deliver value to clients," says Scott Devine, head of legal and professional services at TheCityUK.

Its figures show that investment in UK lawtech has tripled over the last two years, with the UK becoming a global hub for a lawtech market worth more than £15bn globally.[33]

In a sector with high barriers to disruption and a preference for doing things the traditional way, the adoption of digital technologies has been relatively slow. But as clients become used to digital innovation in other sectors and margins are squeezed, that is changing.

The pandemic accelerated the trend towards virtual law firms that operate remotely without physical offices, using platforms for meetings and client interaction.[34] Location is no longer a barrier to serving clients, whether in the UK or globally, Devine points out. "Digital and AI technologies are lowering costs, bringing previously exclusive services with reach of a much wider customer base as well as enabling justice to be delivered more efficiently," he says.

"For example, the Business and Property Courts in the UK moved online seamlessly during the pandemic, enabling them to hear around 85% of their pre-pandemic caseload, continuing the trend to make access to justice more flexible and responsive to the needs of businesses and citizens."

Section 03

Finance and the sustainability imperative

03

Finance and the sustainability imperative

Sustainability and the fight against climate change were rising rapidly up the trade agenda even before the pandemic shone a harsh spotlight on corporate resilience and vulnerability to long-term risks.

Net zero cannot be achieved without financial services providing the funding needed to mitigate the physical risks of the impact of climate change.

If the world is to limit the global average temperature increase to 1.5°C above pre-industrial levels by 2050, as agreed in Paris in 2015, the financial services industry has a key role to play. Net zero (where remaining greenhouse gas (GHG) emissions are balanced out by an equal amount of GHG removals) cannot be achieved without financial services providing the funding needed to mitigate the physical risks of the impact of climate change and transition risks from the shift to a low-carbon economy.

Climate financing

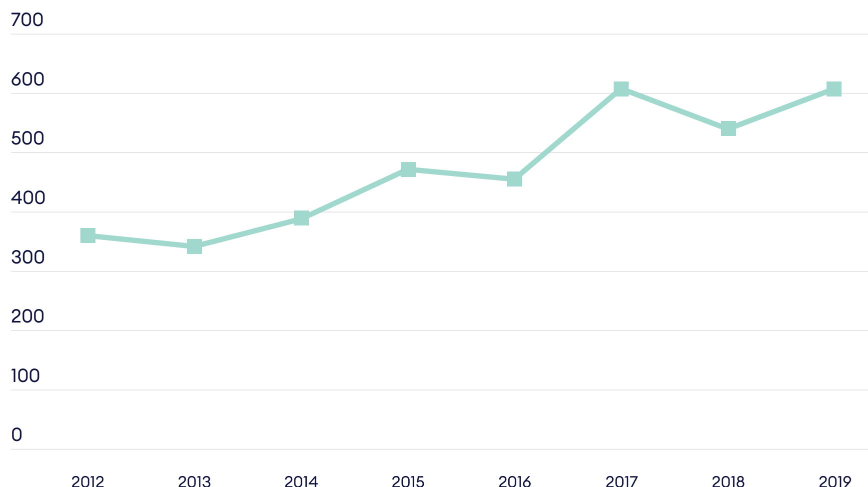
Climate finance is defined as the allocation of capital in a manner "that supports the transition to a climate-resilient economy by enabling mitigation actions, especially the reduction of greenhouse gas emissions, and adaptation initiatives promoting the climate resilience of infrastructure as well as social and economic assets generally".[35] In other words, it's the money that's needed to fund activities that will slow climate change and contribute towards the 1.5°C target being met.

Financing a transition to a climate-resilient economy will require much greater investment than is currently being committed, not only to mitigate climate risks but to direct a bigger proportion of private savings globally towards sustainable investments. Boston Consulting Group (BCG) and the Global Financial Markets Association estimate that US$100-150trn will be needed to reach the 2050 1.5°C target, amounting to an average investment of US$3-5trn a year, which would represent up to an eight-fold increase on current levels.[36]

Failure to provide the required investment now will result in even more investment being needed for climate adaptation and mitigation in the longer term. The US$100bn a year that developed countries committed to providing by 2020 in support of climate action in developing countries was not met, according to the most recent data, which put the figure at just US$79bn. While investments in renewable energy and sustainable infrastructure continue to grow, more money was spent on fossil fuels in the first three months of 2021.[37]

Global climate financing flows were estimated by the Climate Policy Initiative (CPI) to sit between US$608bn and US$622bn in 2019, the bulk of which was in the form of debt issuance. The vast majority of private financing has been directed towards transport renewable energy projects, reflecting an investor preference for more commercially viable sustainable projects and industries.[38] "Energy and transport are the sectors that have cost-competitive, low- and zero-carbon technologies and business models," points out Nathan Fabian, chief responsible investment officer at the Principles for Responsible Investment (PRI).

Figure 5: Climate finance growth: *Total global climate finance flows (US$bn), 2012-2019*



Source: Climate Policy Initiative

Mounting regulatory expectations from central banks and supervisors are adding to the powerful set of pressures driving climate efforts by financial institutions."

Nick Robins, Professor in Practice, Sustainable Finance, Grantham Research Institute on Climate Change and the Environment

The biggest gaps for realising the SDGs are in emerging markets across almost all goal areas. "In terms of the goals themselves, there are still huge gaps in physical infrastructure for low-carbon transport, communications, clean water, health, education. The list goes on," says Fabian. While corporations accounted for the majority of private investment in 2017/18, commercial financial institutions, institutional investors and smaller funds played an increasingly significant role.

It's gradually becoming easier for institutions and fund firms to examine whether their own investments enhance or undermine sustainability outcomes, as sustainability and Environmental, Social and Governance (ESG) data become more consistent and accessible. This allows them to monitor and disclose their sustainability performance to their clients and beneficiaries. "Those with an investment approach that targets positive sustainability outcomes, because of their investment thesis or specific client demand, can steward their investments and allocate capital consistent with this approach," says Fabian.

Regulatory requirements

The growing prominence of institutional and private investment in climate financing to some extent reflects regulatory efforts to drive climate-related activities up the financial services agenda.

Regulation is, in turn, responding to market developments such as green bonds, the setting of portfolio sustainability targets and sustainability-integrated investment mandates.

"Mounting regulatory expectations from central banks and supervisors are adding to the powerful set of pressures driving climate efforts by financial institutions," according to Nick Robins, professor in practice, sustainable finance, at the Grantham Research Institute on Climate Change and the Environment. "Growing government climate pledges along with accelerating clean tech dynamics as well as demands from shareholders and customers have already tipped the financial system in favour of net zero. The challenge now is to translate these commitments into short-term action in terms of capital reallocation in the 2020s".

Efforts to improve climate-related industry risk disclosures began in earnest in the wake of the 2015 Paris Agreement, with the launch of the Taskforce on Climate-related Financial Disclosures (TCFD). In 2017, the TCFD published recommendations under four categories - governance; strategy; risk management; metrics and targets - that now help shape the disclosure requirements set out by global policymakers.

The fact that the TCFD is now providing a common basis for international disclosure standards can accelerate this transition risk."

Nathan Fabian, Chief Responsible Investment Officer, Principles for Responsible Investment (PRI)

The Financial Conduct Authority's new disclosure requirements for UK-listed companies in January 2021, for instance, were directly aligned with the standards set by the TCFD.[39]

The TCFD has helped companies and investors to look forward and better understand how close and disruptive the climate-policy-driven economic transition may be, according to Fabian. "This is a good step, but not enough to drive widespread repricing of risk or capital reallocation," he says.

"The fact that the TCFD is now providing a common basis for international disclosure standards can accelerate this transition risk. This in turn shifts the climate-risk conversation from a governance-only discussion to a balance-sheet discussion, which is where it should be."

Similarly, the UK government will, from October 2021, require the largest workplace pension schemes and master trusts to report in line with the TCFD's recommendations.[40] Regulators and central banks increasingly require financial firms to explicitly account for climate-change-related financial risks in their risk management, and to be more transparent about their exposure to climate-change risks.[41]

In the UK, for example, the Prudential Regulation Authority (PRA) published a statement in 2019 setting out its expectations of firms in their management of financial risks from climate change, with the likely effect of incentivising firms to invest more in green assets that aren't exposed to climate-change risks.

As of 2020, the Bank of England also publishes its own annual climate-related financial disclosure report, outlining its approach to managing risks from climate change across its operations. In its most recent update, it noted that carbon emissions associated with its financial holdings had fallen since the inaugural report and that it had significantly reduced the carbon footprint from its physical operations. The bank is among several central banks now integrating climate risk into financial stress testing scenarios.

With poor stress test outcomes potentially impacting share prices, this is seen as a notable incentive for financial institutions to take climate risks more seriously.[42]

Elsewhere, the European Central Bank (ECB) is consulting on draft standards for disclosures on ESG risks. The standards set out by the ECB include a green asset ratio, which 'identifies the institutions' assets financing activities that are environmentally sustainable according to the EU taxonomy, such as those consistent with the European Green Deal and Paris agreement goals. Green asset ratios are among a raft of metrics designed to help investors take the physical and transition risks of climate change into account in their investment decisions.

However, much more is needed to incentivise climate financing from the investment industry. While there are signs of financial authorities starting to align their operations with net zero, according to a recent report by the Grantham Research Institute, a more systematic approach is now required. The report recommends, among other measures, the introduction of a requirement for all financial institutions to submit net-zero transition plans and address climate risks in regulatory ratios. It said that the TFCD should include net zero, which should also be incorporated into key international financial and regulatory frameworks and processes.[43]

More broadly, the two main areas of incentive are pricing (taxes) and rules that limit emissions, according to the PRI's Fabian. While Europe is making progress with its Fit for 55% package, which aims to reduce net GHG emissions by at least 55% by 2030, compared to 1990 levels, other markets need to follow suit, he warns. "But demand for sustainable investments is also growing rapidly, so market-friendly reforms that increase confidence in environmental performance of investments also matter," Fabian adds. "This is where the taxonomy comes in. The market needs benchmarks of environmental performance because the pricing and emissions rules are still lagging behind the social cost of carbon emissions."

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