Greening finance

Government policy, the finance gap, and the sustainability challenge

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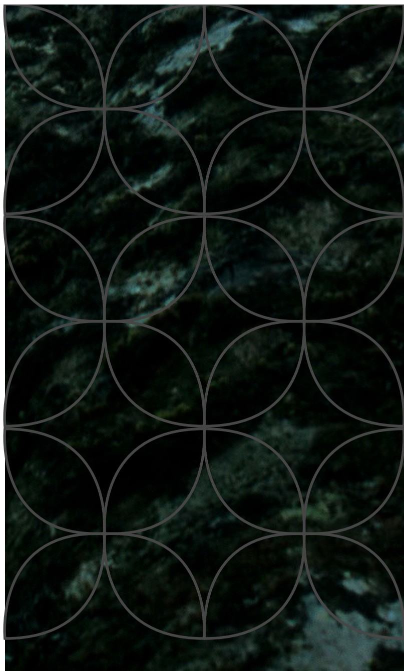

Managing climate change and achieving net-zero carbon to cap global warming at 1.5 degrees celsius and save humanity is among many other things, expensive. An estimated USD 131 trillion in global investments is required to facilitate the transition to clean energy and preserve our planet.[1] This represents a significant increase from pre-pandemic estimates and the ongoing energy supply crisis.

Despite commitments and actions taken by a number of countries, four key challenges to “Green”ing finance persist and require immediate action by governments that are coordinated with businesses and civil society alike:

1. **The devil in the details:** A common understanding of green finance
2. **A delicate balance:** Immediate concerns versus long-term gains
3. **Demand minus supply?** Creating a viable asset base
4. **Dotting the lines:** Country responsibilities to a global financial order

1. International Renewable Energy Agency (IRENA), “World Energy Transitions Outlook”, June 2021”, https://irena.org/publications/2021/Jun/World-Energy-Transitions-Outlook

1 The devil in the details

A common understanding of green finance

While the current focus on sustainability has raised awareness of green finance and the policy tools needed to address it, setting and actioning priorities and focus points remains a contentious issue. From a government perspective, green finance deploys financial policy tools to support capturing and internalising environmental externalities and creating a supportive ecosystem for sustainable investments. Policy measures are used to raise awareness and divert use of high energy emissions, as well as incentivise investment and adopt technologies that minimise and reverse damage to our environment. Significant gains have been made: over the past seven years, the rise in reneweable energy surpassed that of fossil fuel and nuclear energy combined. Of the 58 million global energy-related jobs generated in 2019, approximately 20% were in the renewable energy sector - with a stronger gender balance than typically found in the oil and gas sector. Technology and the direct use of renewables are driving green investment and increasing appetite for investment in this important sector.[2]

That said, the absence of regulatory standards and parameters of green finance means that risks persist - specifically in quantifying and qualifying investments. One of the main challenges associated with this lack of clarity is “greenwashing” - the practice of giving misleading or false claims about the environmental performance of products and services by businesses and investment funds. Greenwashing creates significant mis-information about environmental performance and its potential and results in market imbalances. It also facilitates the misallocation of green funding and support towards “brown” products.

Information asymmetry does not only exist at the business level. Many governments have not clearly announced the extent of their climate action commitments and how they plan to action them. This impacts the risk perception of making green investments, and in turn, investor appetites. By early 2021, 160 countries had set active targets for renewable energy in their national strategies. As actioning these targets is left to the discretion of individual governments, again, the absence of regulatory clarity and definitions has left significant room for interpretation as to what the priorities are and resulted in delays in implementation.[3]

2. International Renewable Energy Agency (IRENA), “World Energy Transitions Outlook”, June 2021”, https://irena.org/publications/2021/Jun/World-Energy-Transitions-Outlook

3. International Renewable Energy Agency (IRENA), “World Energy Transitions Outlook”, June 2021”, https://irena.org/publications/2021/Jun/World-Energy-Transitions-Outlook

2 A delicate balance

Immediate priorities versus long-term gains

Speaking at the opening session of Davos 2022, Fatih Birol, Executive Director of International Energy Agency told the world that it needs to stop looking beyond its immediate energy needs and make long term, sustainable investments for the future.[4] Birol's statement captures the core challenge facing global governments. Rising inflation, high interest rates, a renewed interest in self-sufficiency and a move towards de-globalisation all against a background of post-pandemic recovery and ongoing geopolitical instability, presents financial policy makers, when it comes to climate change and sustainability, with a series of conflicting policy decisions and choices. No doubt, the immediate priority is supporting society's most vulnerable social groups - coincidently the hardest hit by the pandemic - with safety nets and tools that soften the impact of the current recession and propel things in motion to move forward. In effect, this has meant that with few exceptions, financial and environmental policies have been fluid, uncoordinated, and mismatched.

With global public debt reaching a record USD 303 trillion in 2021, there is no doubt that public budgets will fall short of the required financing and will have to "bank" on private investors with support from government and/or international financial institutions in the form of priority lending, interest rate subsidisation, and refinancing opportunities. The bulk of these investments are likely to be in clean energy solutions. Estimates indicate that phasing out fossil fuels entails redirecting USD 24 trillion in planned investments into carbon efficient, "clean" investments, with over 90% of these solutions mostly (technology) clean energy investments.[5] In addition to prioritising these financial tools for climate change mitigation over socio-economic considerations, an added challenge to green investment is demonstrating the long term gains and return on investment to investors in a niche, relatively new, and mostly misunderstood sector.

4. World Economic Forum, "Davos 2022: We are in the middle of the first global energy crisis. Here's how we can fix it". May 2022, https://www.weforum.org/agenda/2022/05/first-global-energy-crisis-how-to-fix-davos-2022/

5. International Renewable Energy Agency (IRENA), "World Energy Transitions Outlook", June 2021", https://irena.org/publications/2021/Jun/World-Energy-Transitions-Outlook

3 Demand minus supply?

Creating a viable asset base

No discussion on green finance would be complete without reference to the finance gap. The financing gap between demand and supply is greatest in the "clean technology", which is the area, as highlighted earlier, where the most investment and focus is needed. These ventures are usually capital intensive and characterised by a high technology profile. With lack of specialist understanding and information gaps in most markets, the finance challenge is increased by unclear exit options for potential investors. In addition, the very nature of the sustainability sector means that the majority of businesses operating in this space lack the credit history and/or the networks needed to easily access finance. Finally, the extended time horizons required for impact and/or change in the environment means that green businesses require investors with an appetite for long term returns on investment.

Green bonds are possibly the most popular green asset today - their total global market value estimated to have passed USD 1 trillion at the end of 2020, and expected to surpass USD 1.5 trillion in 2022.[6] Distinguished from traditional bonds by the fact that they are directed to sustainably sound investments;[7] since the launch of Green Bonds by the World Bank and the Swedish Bank SEB in 2008, many organisations and governments have resorted to them as a stable, secure alternative form of green finance. In fact, so much so, that analysts have argued that within a general environment of a shortage of green assets, green bonds are the only green asset class with a significant supply, and have raised concerns regarding their potential impact on sustainability. As highlighted earlier, the absence of standards and regulations determining "green" raises risks of greenwashing. This risk is raised by the fact that studies have found that 90% of issued green bonds are investment grade issuances (medium to high credit) and that the returns from green bonds are, on average, significantly lower than conventional bonds. Effectively, this means that the majority of green bonds could have been issued as conventional bonds with little difference to the issuer's ability to secure capital at favorable rates,[8] and explains the levels of demand that are unmatched against supply.

6. World Bank, "Green. Social, and Sustainable Bonds to Meet Africa's Sustainable Investment Needs", May 27, 2022, https://www.worldbank.org/en/news/press-release/2022/05/27/afw-green-social-and-sustainable-bonds-to-serve-africa-s-sustainable-investment-needs#:~:text=The%20global%20sustainable%20bond%20issuance,surpass%20%241.5%20trillion%20in%202022.
7. Green bonds are regulated by two internationally recognised standards - the "Climate Bond Standard & Certification" established by the Paris Agreement of 2016, and the "Green Bonds Principles".
8. Maltais, Aaron and Bjorn Nykvist, "Understanding the Role of Green Finance in Advancing Sustainability", Journal of Sustaianable Finance & Investment, 14 February 2020, https://www.tandfonline.com/doi/full/10.1080/20430795.2020.1724864

4 Dotting the lines

Country responsibilities to a global financial order

Growing evidence shows that global inequalities are increasing - at both the national and transnational levels. 97% of new sustainable investment funds are concentrated in high-income countries, highlighting the potential and scope for green finance in the developing world.

Recognising this, the 55 countries responsible for approximately 55% of the world's greenhouse gas emissions committed in the Paris Agreements of 2016, among other things, USD 100 billion in climate finance by 2020 and to continue to invest at this level until 2025. While trillions of dollars are needed to adequately meet the goals set by the Paris Agreement, this pledge is significant as a gesture of goodwill and responsibility towards the broader global economy. In the absence of clear measures or guidelines to measure progress towards fulfilling these obligations, it is hard to quantify the contributions that have been made. A report by the Organisation for Economic Cooperation and Development (OECD), using data submitted by the wealthy nations themselves, estimates that USD 78 billion and USD 80 billion in contributions were made by developed countries to developing countries in 2018 and 2019 respectively. Importantly, these figures have been disputed as overly inflated, with the argument that as the bulk of the money has come through grants and loans, the calculation of the value should be based on the value of the below market interest and not the full size of the loan. Another argument is that some countries count the full amount of their development aid as going towards climate change - regardless of the nature of the development project it is funding. It is argued that this calculation would place the total actual contributions within the range of USD 19 - 22.5 billion.[9]

The bulk of the transnational finance that has been provided has been directed towards middle income (as opposed to low income) countries, with estimates that only 8% - 2% of the funds reach the countries in most need. In addition, the bulk of the funding has focused on reducing greenhouse emissions.[10] While useful as a means of mitigating the impact of climate change, it does not address the core focus point of many developing countries: adapting and adjusting livelihoods to cope with the changes put in place by the climate crisis. The question of the nature of the funding that developing countries receive loops back to broader issues in the multilateral order. Grants and loans to developing countries to mitigate the impacts of climate change are an "easier sale" for governments that have to justify these budget allocations to their constituents. Private capital investors are comfortable with projects that demonstrate tangible impacts and consequently returns. To address this issue - the V40 (the top 40 countries most impacted by climate change), have adjusted their demands. Instead of focusing on the USD 100 billion 2022 pledge, they are looking for a plan that demonstrates how developed countries will deliver on the USD 500 billion over the next five years.[11]

9. Timperly, Jocelyn, "The broken $100-billion promise of climate finance — and how to fix it", Nature, October 2021, https://www.nature.com/articles/d41586-021-02846-3
9. Timperly, Jocelyn, "The broken $100-billion promise of climate finance — and how to fix it", Nature, October 2021, https://www.nature.com/articles/d41586-021-02846-3
9. Timperly, Jocelyn, "The broken $100-billion promise of climate finance — and how to fix it", Nature, October 2021, https://www.nature.com/articles/d41586-021-02846-3

Key actions

We propose four key considerations for governments to strengthen and enhance green finance.

Build towards a universally recognised regulatory framework for green finance

As outlined earlier, limited regulations and guidelines in defining green finance has resulted in information asymmetry in the market, uncoordinated government policies, and greenwashing. In 2021, the European Union (EU) released the “Sustainable Finance Disclosure Regulations” as a key pillar of the EU Sustainable Finance Agenda. This represents an important first step in setting global standards and frameworks to guide and channel green finance, and provide investors with the reassurance that they need.

Scaleup (and out) innovation success

Showcasing success stories in green finance at the national and international levels has great potential to generate impact. It will also allow countries with ongoing social and economic challenges, who are not accessing sustainable finance, to leap-frog their financing needs. Distilling key features of success and how they can be tailored to specific contexts is key.

Diversification of green finance policy tools

The financial sector has always been a key driver of change in the economy, with the general rule of thumb being that more often than not, the biggest risks yield the highest returns. Beyond the loans and green bonds that dominate the sustainable finance market, we propose direct intervention in the real economy in the form of subsidies, state credit guarantees and preferential taxes that reflect the learnings of previous years with small and medium enterprise finance.

An integrated, holistic policy approach to green finance

Against a backdrop of dynamism and disruption, governments are likely to continue to face conflicting, shifting policy choices. Engaging the key stakeholders to green finance, namely, commercial and investment banks, capital markets, private investors, and development financiers alongside government in the strategy development process is paramount to striking the right balance and “greening” finance.

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