Long-term finance for climate action

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Mobilising private capital for long-term climate finance

- Private finance – notably investors - are a relatively new stakeholder in climate policy, and are showing increasing commitment to low-carbon, climate resilient development

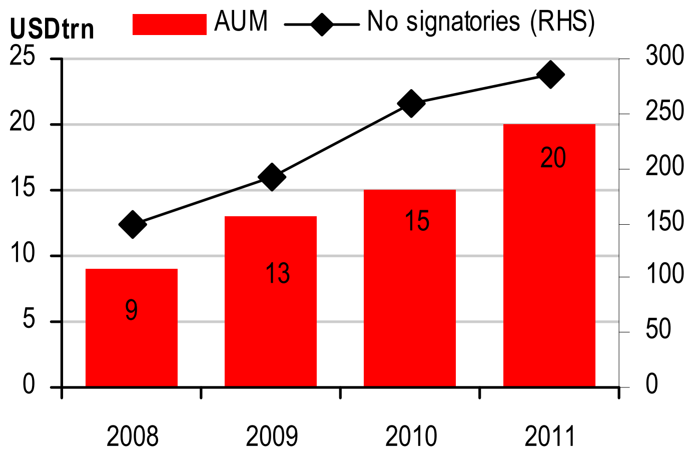
- The key is to bring together the worlds of finance and climate policy, both of which are seeking long-term solutions

- This requires attention to six critical factors:
  - Building 'investment-grade' climate policy
  - Delivering public finance to overcome market failures
  - Channelling private finance demand for low-carbon assets
  - Responding to the capital intensity of low-carbon growth
  - Mainstreaming climate and sustainability in financial policy and incentives
  - Building credible market data for private climate flows

Growing commitment to low-carbon, responsible investment

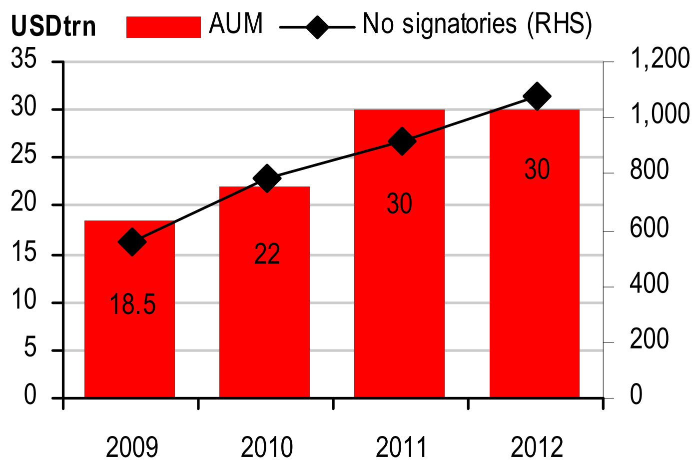
Annual Investor Statement on Climate Change (AUM)

Assets under management (number of signatories)



Principles for Responsible Investment (AUM)

Assets under management (number of signatories)



Source: IIGCC, UNPRI

This is critical because a low-carbon economy is capital-intensive

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Bringing together the Worlds of Finance and Climate Policy

The World of Finance: key issues

- Financial crisis, volatility and short-termism
  - "We conclude that short-termism is a problem in UK equity markets, and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain"

    Kay Review on Equity Markets and Long-term Decision-Making, 2012

- Capital rationing and regulatory reform
  - "Basel III and Solvency II Regulations could bring a sea-change in global project finance funding"

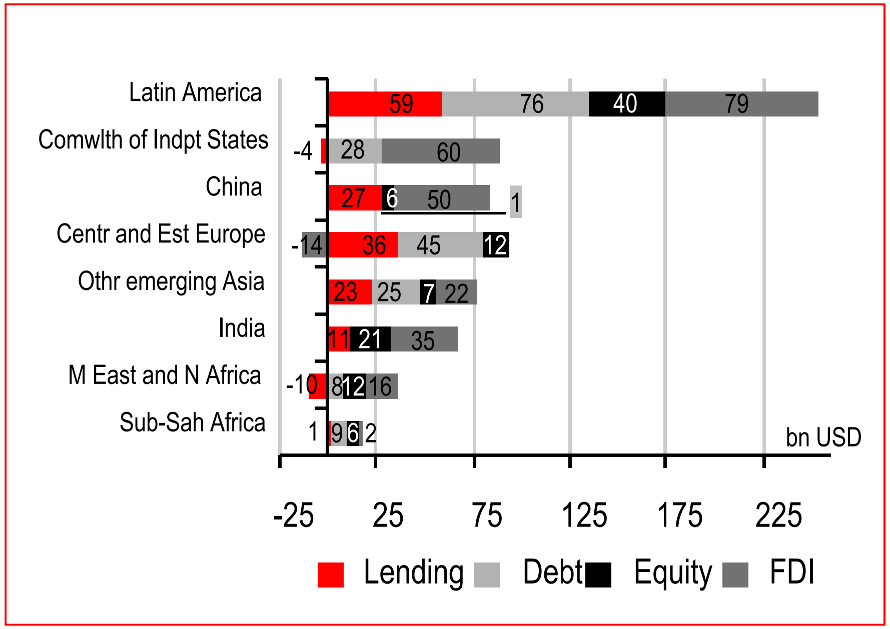
    Standard & Poors, October 2011

- Demand for long-term assets, including environmental infrastructure
  - "We call for a significant increase in global bond issuance to be dedicated to finance for an acceleration of the transition to low carbon growth"

    Climatewise, December 2011

Understanding global capital markets: stocks and flows

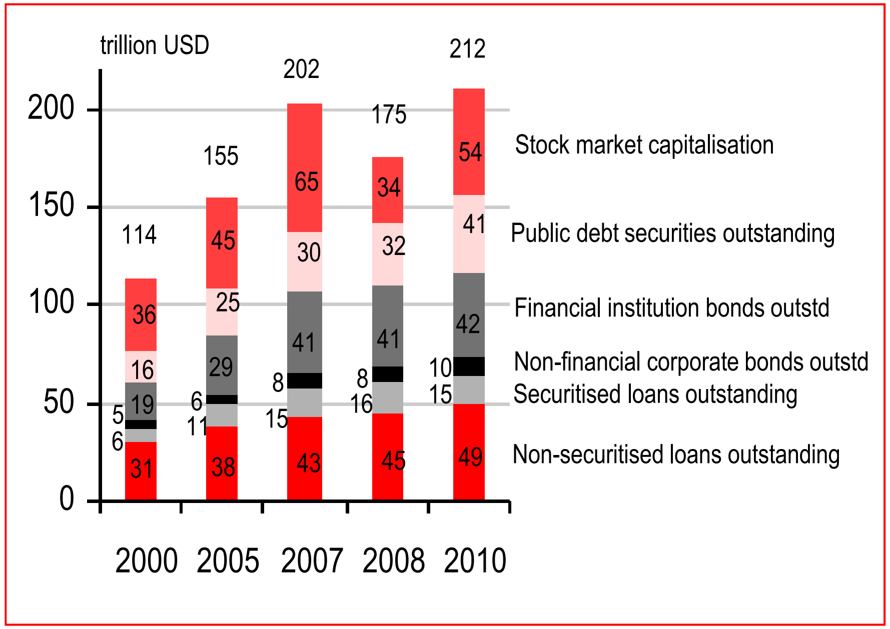
Flows: capital inflows to emerging markets in 2010



Source: McKinsey Global Institute, Mapping global capital markets, 2011 NB definition of emerging economies not necessarily consistent with UNFCCC definitions

Inflows of USD702bn outpaced by outflows of USD922bn, 55% of which from central banks

Stocks: Value of global capital markets 2000-2010

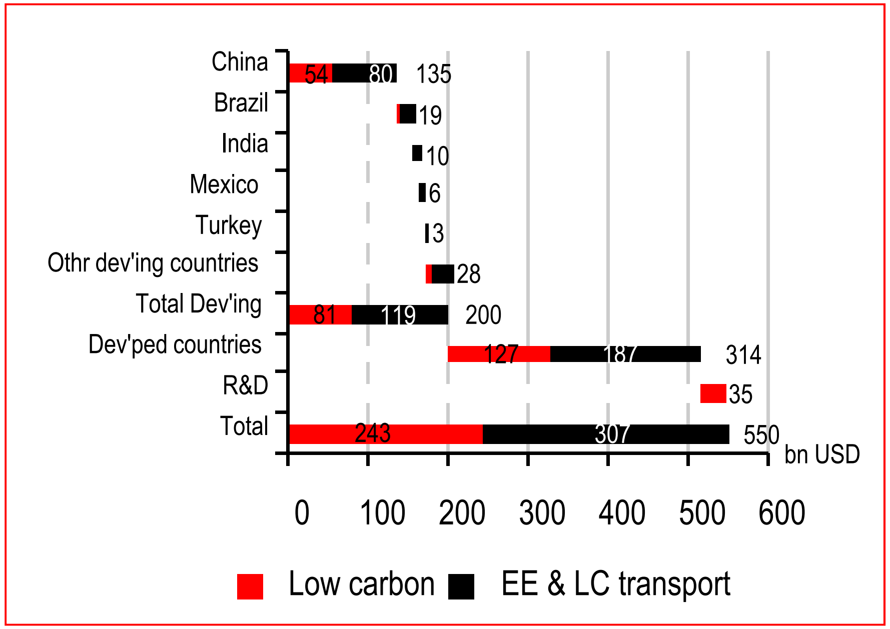


Source: McKinsey Global Institute, Mapping global capital markets, 2011

We estimate that c5% global stock markets now represented by climate solutions

Grappling with climate finance flows

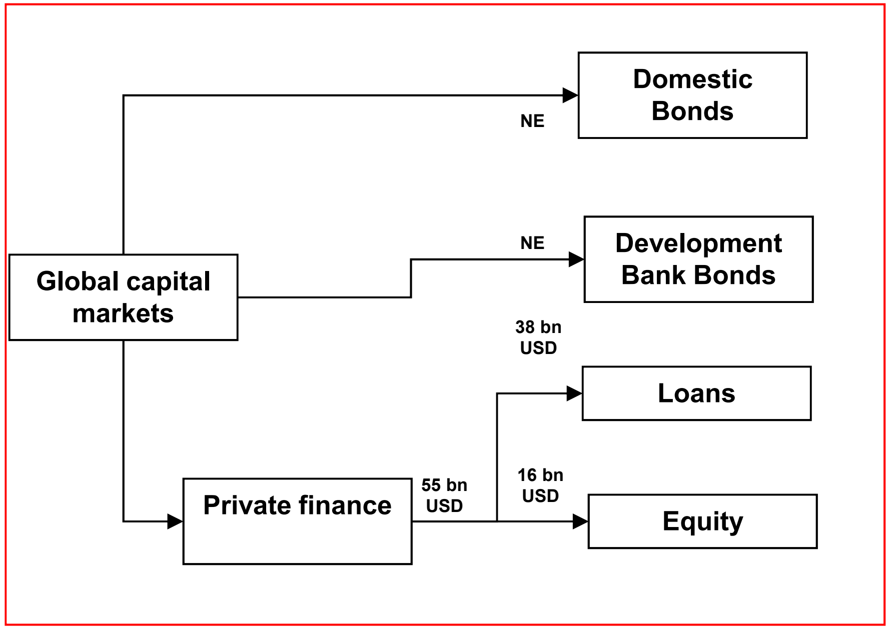
Global Sustainable Energy Investment, 2010



Source: BNEF, HSBC, World Bank Group

Only USD24bn invested outside China, India, Brazil, Mexico and Turkey

USD55bn of private climate finance flows, 2009/10



Source: Climate Policy Initiative, Landscape of Climate Finance, 2011 Note: NE = Not Estimated

This suggests that c8% of total capital flows to emerging economies are climate finance

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1. Building ‘investment-grade’ policy to level the playing field

- The investment playing field still tilted away from low-carbon, resilient options:
- Key components of ‘investment grade’ policy:
  - Clear climate targets and enforceable mechanisms
  - Comprehensive policies that accelerate deployment
  - Financial incentives that shift the risk-reward balance in favour of low-carbon assets
  - Focus on scale to reduce unit costs and build up expertise
  - Be transparent, long-term and consistent
  - Avoid retroactivity
  - Align with wider policy goals: economic, energy, resources
  - Work towards a binding international treaty
  - Support international carbon markets that provide strong and sustained price signals
  - Support the development of the Green Climate Fund (GCF) to scale up climate finance flows

Source: IIGCC, INCR, IGCC, UNEPFI, Investment Grade Climate Policy, 2011

2. Delivering public finance to overcome residual market failures

- A growing body of practical mechanisms to leverage private capital
- For example, a basket of leverage mechanisms for mitigation action by the GCF
  - A mono-line insurance mechanism providing first loss guarantee
  - A clean energy loan guarantee mechanism
  - Mezzanine debt enhancement
  - Subsidised feed-in tariffs for renewable energy (eg GET-FiT)
  - A bankable power purchase agreement-like agreement for energy efficiency
  - A pooled fund for small-scale VC to promote low-carbon social enterprise in LDCs
  - Revolving fund low-carbon social enterprise focusing on energy access
  - Advanced market commitment for bio-carbon investments
  - A political risk insurance mechanism for climate investments (‘Climate MIGA’)
  - A public-private fund to absorb potential first loss from high risk investments in LDCs

Source: CMIA, CERES, IGCC, IIGCC, PRI, UNEPFI, Recommendations for mechanisms to leverage private finance by the GCF, May 2012

3. Channelling private finance demand for low-carbon assets

- Translating latent demand of mainstream asset owners (pension funds, insurance companies) into deal flow
- Debt capital markets a particularly promising area for expansion. Three priorities:
  1. Third party certification of climate bonds would reduce reputational risks and enhance liquidity
  2. Aggregate deals into meaningful deal size (USD500mn) across themes and regions
  3. Use public finance to reduce risk (eg tax incentives, export credit guarantees, credit enhancing project bonds)

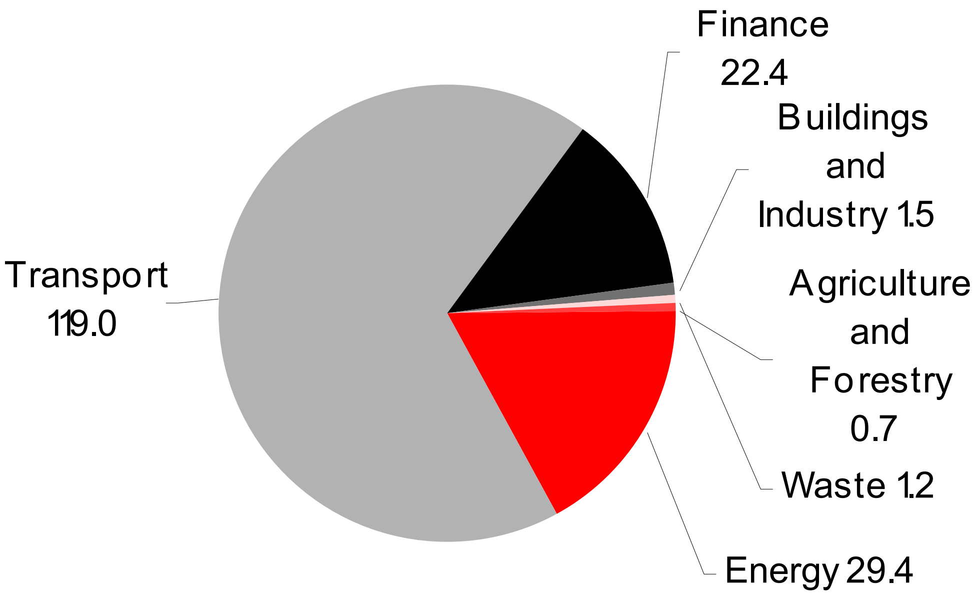
- Harnessing the emerging asset class of impact investing for climate action
  - Investments deliberately designed to create positive social and environmental impact alongside financial return, particularly in deveoping countries
  - Investment potential of USD400bn – USD1trn between 2010 and 2020 across housing, water, health, education and financial services; low-carbon energy additional

Source: Climate Bond Initiative, HSBC, J.P. Morgan

Sizing the climate-aligned bond market: USD174bn

- Over x20 development bank issuance of 'green bonds'

- But still a tiny fraction of total bond markets



<u>Bond Types</u>

- Corporates (82%)

- Finance (13%)

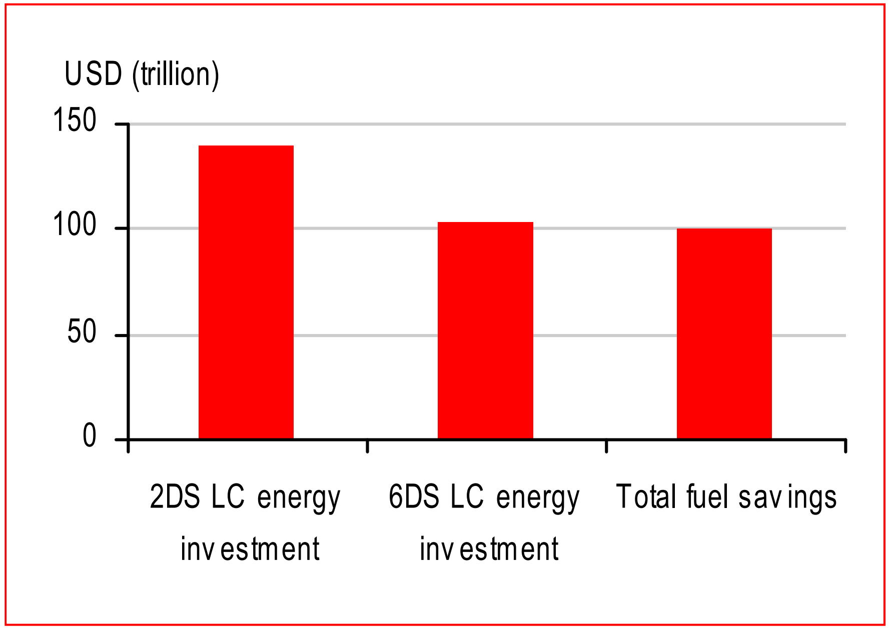
- Project bonds (3%)

- Municipals (2%)

Source: Bloomberg, Climate Bonds Initiative, HSBC

4. Responding to the capital intensity of low-carbon growth

IEA Scenarios for Energy Investment 2010-2050



Source: IEA, Energy Technology Perspectives, 2012

- Important to recognise that costs and investments are not the same
- Low-carbon development requires more upfront capital, but lower operating costs
- The IEA's latest Energy Technology Perspectives projects USD140trn in its 2 degree scenario, compared with USD104trn in the conventional 6 degree world
- But this extra USD36trn in investment delivers USD100trn in fuel savings
- Critical for policy discussions of 'incremental costs'

5. Mainstreaming climate and sustainability in financial policy

- Core financial regulation and incentives are powerful drivers of investment flows – but limited integration of climate and wider sustainability factors to date

- Mainstreaming climate factors could be pivotal for unlocking financial flows

  – Ensuring that Basel III and Solvency II positively contribute to financing long-term low-carbon assets

  – Incorporating climate performance into routine incentives for pensions and savings
    – UK: £30bn p.a in tax incentives for savings and pensions; no link with climate finance

  – Integrating climate risks into management of macro-prudential risks to the financial system
    – Proven reserves of fossil fuels are greater than can be exploited if the 2 degree is to be achieved, posing a risk of stranded assets

Source: Green Alliance, Carbon Tracker Initiative

6. Building credible market data for private finance flows

- Lack of common definitions of climate finance is hampering investment decisions

- Good data on renewable energy does not exist for energy efficiency markets - buildings, industry, transport

- No agreed framework for tracking private finance flows

- Potential to build on existing and emerging disclosure initiatives
  - Carbon Disclosure Project
  - Asset Owners Disclosure Project

Disclosure appendix

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