Global Climate

United Nations Climate Change

Cross-cutting roundtable: Climate-Action and Finance

Outcome Document
Mobilizing climate-aligned investment

UNFCCC COP 24
Katowice, Poland

Marrakech Partnership for Global Climate Action

Saturday, 8 December 2018
13:15 – 14:45

High-Level Champions
Support organisations - *Asia Investor Group on Climate Change, CDP, Ceres, Investor Group on Climate Change, Institutional Investors Group on Climate Change, Principles for Responsible Investment and UNEP Finance Initiative, International Finance Corporation*

Financing climate action: how to mobilize investment at scale and speed

This note is the Facilitator's Summary of the wide-ranging discussion at the Global Climate Action Roundtable on Mobilizing climate-aligned investment on 8 December 2018 at COP 24 in Katowice.

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Growing leadership – but still structurally insufficient

The evidence is clear. Leaders in the world of finance are responding to the strategic threat of climate change in unprecedented ways. Nearly 400 investors representing US$32 trillion in assets under management (AUM) are taking action on one or more areas of the globally coordinated Investor Agenda.[i] In the run-up to the Katowice COP24 itself, the New York State retirement funds announced a 30% increase in their allocation to sustainable investment, taking the total to $10bn.[ii] Shareholder engagement is also delivering real results in terms of companies shifting their climate strategy, with a joint statement from Shell and leading investors providing a powerful example that activism can deliver real change.[iii]

The multilateral development banks (MDBs) have also united under a common framework to increase their flows of finance to support low-carbon and resilient development.[iv] We now have an internationally consistent framework through the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) for companies and financial institutions to report publicly on their activities.[v] A growing number of countries and regions – such as Canada, China, the EU and Morocco – are putting in place roadmaps to drive sustainable finance. And 24 of the world's top central banks and regulators have come together in the Network for Greening the Financial System (NGFS) in the face of climate shocks.[vi]

Many of these developments would have been unthinkable just three years ago, when the Paris Agreement on Climate Change was signed. Yet although "more money than ever is being invested in climate action" according to the latest assessment from the Climate Policy Initiative[vii], this falls far short of what is needed to deliver the goals of the Paris Agreement, not least its objective of "making financial flows consistent with a pathway towards low greenhouse gas emissions and climate resilient development". There remains a lack of urgency in large parts of the financial system – and as Fiji's High-Level Champion for climate action Inia Seruiratu underlined at COP24: "we don't have the luxury of time", not least the developing countries most vulnerable to climate change and receiving least climate finance.

Closing this gap requires action by both investors and policymakers. Investors themselves need to do much more, moving beyond simply understanding the risks and opportunities of climate

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[1] This note is the Chair's Summary of the wide-ranging discussion at the Global Climate Action Roundtable on Mobilizing climate-aligned investment on 8 December 2018 at COP 24.

change to setting targets for making their portfolios climate consistent and then allocating capital accordingly. To make this happen, investors also need to see policy action to ratchet up policy ambition in each country's Nationally Determined Contributions (NDCs) so that they match the goals of the Paris Agreements, build investor confidence and reward determined action. At the Roundtable, participants identified five priorities so that investment can flow at the scale and speed required: get systemic, focus on developing countries, change the rules of the game, build and de-risk the asset pipeline and step up the pace of international cooperation.

Getting systemic about financing climate action

Efforts to mobilise finance needs to focus on the financial system as a whole – the $386 trillion of assets across the world in banks, investors and other institutions. Imagine a simple traffic light. A climate-aligned financial system would certainly involve substantial increases in the volumes of 'green' finance, but it would also involve reductions in the amount of 'red' finance that is misaligned with the goals of the Paris Agreement, as well as a shift in the large proportion of capital that is currently in-between in the 'amber' zone. As a start, the various data that measure these volumes should be brought together in a user-friendly manner in one place, then monitored and updated regularly by the relevant institutions.

Getting systemic also means connecting the different layers of the financial system from top to bottom – from the global frameworks within the UNFCCC through the national-level climate plans and NDCs to the city and local level.

Importantly, a systemic approach also requires action to make the linkages between climate action and wider efforts to implement the Sustainable Development Goals (SDGs). For financial institutions, the transition to a resilient, net-zero economy has profound environmental, social and governance (ESG) dimensions. In particular, these efforts to shift large flows of capital have to be placed in a broader social context of building an inclusive economy. Ambitious climate action provides a highly attractive model for prosperity and the creation of additional quality jobs. For banks and investors, this means working with other stakeholders to support a Just Transition. This is a key theme emerging from COP 24 with the Silesia Declaration on the Just Transition launched by the Polish Presidency on the first day with support from over 50 governments.[viii] A new investor guide to the just transition was also released at COP24 with the backing of institutions with $5trillion in AUM.[ix]

Focus on the needs of developing countries

To date, most of the efforts to mobilise finance from banks and investors has involved institutions based in high-income countries. However, it is the developing world that is most at risk from the impacts of climate change, where the needs for capital to build sustainable infrastructure are greatest and where access to finance is weakest.

A number of practical steps can be taken to refocus on developing countries. One place to start is with the domestic asset base within developing countries – for example, the $700bn in pension assets in Africa or the $40 trillion in bank assets across the emerging world. These pools of capital are structurally more exposed to both the upside potential of low-carbon and resilient growth as well as the downside risks from rising physical impacts. Greater domestic engagement also provides a strong basis for international cooperation with foreign institutional investors.

International investors can also ensure that their efforts to reallocate capital and engage with the companies they own also has a clear emphasis on developing countries. A particular priority is to work with companies in developing countries to generate the data and disclosures required to respond to the TCFD recommendations.

Adaptation financing also needs to substantially increase to address the higher impact of extreme weather to society due to climate change, especially in developing countries[x]. Yet, due to the large size of the adaptation financing gap and constrained public finances, private investment will also need to make a considerable contribution to adaptation financing. Adaptation projects can be shown to be cost effective and bring wide range of resilience benefits. To demonstrate the value of resilience benefits to various stakeholders it is important to quantify those benefits based on a robust modeling framework.

New markets need to be created and engineered, with a particular focus on connecting the fundamental needs of billions for access to credit, savings and insurance with the climate finance agenda. Major efforts are required to aggregate these micro transactions into products that can be attractive to both domestic and international investors.

All of this requires practical on the ground capacity building in terms of skills and knowledge with financial institutions, within financial regulators and other key stakeholders.

Change the rules of the game

A core reason for the continued misalignment of capital with the Paris Agreement is that the rules of the game still reward short-term thinking that disregards climate factors.

A core starting point is clear and reliable policy frameworks from governments, such as the European Commission's recent 2050 Climate Neutral proposals. The high-level Nationally Determined Contributions (NDCs) submitted before Paris need to be translated into detailed plans that produce a stream of bankable projects. A shared language is also needed so that institutions can allocate capital with confidence to activities that deliver real progress for the climate and other sustainability priorities. Here the EU's emerging sustainable finance taxonomy offers considerable promise for enabling institutions to tag their assets in a consistent way.

Central banks and regulators can also do more to make climate risk a routine part of their micro- and macro-prudential frameworks, focusing more on the long-term risks around high-carbon assets. This is includes integrating TCFD recommendations into core corporate reporting frameworks. Furthermore, a long-standing condition for finance to flow in the right direction is for market prices to tell the climate truth. This means removing perverse subsidies for fossil fuels and pricing carbon. These reforms need to be carefully designed with full dialogue to incorporate the social dimension, so that low-income communities are better off as a result.

Build and de-risk the asset pipeline

These steps are crucial to build the flow of climate-aligned assets that meet the risk-return needs of long-term investors such as pension funds and insurance firms. There are potentially significant opportunities in private markets (particularly infrastructure projects), where investors

can play a critical role as responsible owners, driving physical risk assessment, climate resilience and emissions reduction.

To realise this potential, more is needed to both build the asset pipeline (notably in developing countries) and then apply tried and tested tools, such as guarantees, credit enhancement and first-loss arrangements to de-risk these transactions (including foreign exchange risks). Leading donor countries and development finance institutions have built up a track record of successful interventions. Looking ahead, these have to become common practice rather than incremental innovations.

Climate-aligned assets also need to be aggregated via capital market instruments into the size that can be managed by large institutional investors. The development of safe securitization market for sustainable infrastructure could be one way to achieve this.[xi] In a white paper released in late 2018, the G20 Sustainable Finance Study Group estimates the bond market could provide USD 1-1.5 trillion annually in additional private capital for sustainable projects – half of the current annual investment gap. However, some structural challenges and market barriers will need to be removed and policies and incentives put in place to ensure adequate returns for investors. Another priority is to expand the market for sovereign bonds focusing on climate action. Two of the COP's presidents – Fiji and Poland – have been pioneers in issuing sovereign green bonds. A leadership group of countries could develop a programme for the coordinated issuance of green sovereign bonds to pump prime their own and global capital markets.

More broadly the urban finance arena offers immense opportunity. The IFC has estimated that there is a cumulative climate investment opportunity of $29trillion across six urban sectors in emerging markets through to 2030. strong potential.[xii] Here again, dedicated efforts are needed to build capacity, for example, in municipal bond markets.

Step up the pace of international cooperation

A golden thread that runs through all these priorities is the need for far stronger international cooperation within and between the different communities with a stake in climate finance strategies that are fit for purpose: governments, financial institutions, corporations, regulators, civil society and indeed the citizens whose savings underpin the system.

An agreement from governments on the Rulebook that will govern the implementation of the Paris Agreement at COP 24 would be important for mobilizing climate finance. Existing policy targets will also need to be brought into line with the needs of holding global warming to well below 2 degrees Celsius and aiming for 1.5 degrees Celsius. Over $30 trillion of investor capital is now backing governments to do exactly this. In addition, other key aspects of the Paris Agreement should be brought to life (such as Article 6).

The international financial community also needs platforms which enable them to better understand the climate finance agenda in developing countries. This includes learning how to deal with potential trade-offs between climate objectives and other environmental goals; as well as unintended social consequences. This is particularly important because people living in poverty or just above the line of poverty are most vulnerable to climate-risks, biodiversity loss or water shortages.

The new Alliance for African Financial Institutions on Climate Change (AFAC) is one example of such a platform. Launched in 2018, AFAC aims to increase financial sector participation in climate action and will do this through knowledge sharing, instruments, disclosures, and risks and opportunities that are fit for the African ecosystem.[xiii]

There is no shortage of capital to tackle climate change. The problem is that the systems, rules and tools are not in place to align the world's $386 trillion in assets with a prosperous, inclusive and secure future. This is the agenda for the next phase of financing climate action.

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[ii] https://osc.state.ny.us/press/releases/dec18/120718.htm
[iii] https://www.shell.com/media/news-and-media-releases/2018/leading-investors-back-shells-climate-targets.html
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[v] https://www.fsb-tcfd.org/
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