The challenge of climate finance

Alexander Lehman and Mark Plant discuss low-carbon transition challenges and consider the EU agenda for coordinating with emerging markets

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Addressing the challenge of financing the low-carbon transition will require substantial investment in the European Union and in emerging and developing economies.

Sustainable finance frameworks have proliferated in advanced and emerging markets but fragmentation of financial flows due to different classification systems and standards for green financial instruments is a real risk. Ensuring consistency should be a core agenda for the new International Platform on Sustainable Finance (IPSF).

Estimates suggest that about 70% of the infrastructure investment needed for the low-carbon transition will have to be deployed in the emerging markets and developing economies (EMDEs). Countries' updated nationally determined commitments, which are due ahead of the COP-26 UN climate summit in 2021, will underline the scale of this challenge.

They are bound to highlight considerable financing shortfalls as resources from national budgets and development funds will be scarce in the aftermath of the current recession.

The substantial investment needs compare with as yet scarce flows of private climate finance. Such flows are at present dominated by development institutions, and by private funds blended with such concessional financing, though the target of an annual $100 billion transfer from the advanced to the developing countries for green investment is not yet met.

A new paper finds that private sources account for just over half of total climate finance mobilized globally, as national development banks and multilateral development banks dominate this area.

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Of the total climate finance for projects in non-OECD countries only between one fifth and one third was derived from cross-border flows, and only 15% of the total global volume of climate finance flowed from OECD to non-OECD countries.

The implementation of the EU's 2018 sustainable finance agenda laid the basis for the financial sector to fund a greater share of the low-carbon transition and to reflect climate risks in prudential regulation. EU rule-making has already produced a number of results: a taxonomy of economic activities aligned with climate policy which will be in effect from 2021; a proposal for a green bond standard; and a regulation on investment funds that can be labelled as supporting the low-carbon transition.

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If the new IPSF is to become a real forum for common rule-making, the EU will need to contend with concerns in other jurisdictions that the EU framework has reinforced the fragmentation of global climate finance

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The revision of the non-financial reporting directive, which would align the EU with the recommendations of the G20 Task Force on Climate Related Disclosures (TCFD), remains under discussion.

What has perhaps been overlooked is that EU regulation will have profound implications for international flows of climate finance, on which developing countries in particular will depend to finance their investments in climate mitigation and adaptation.

EU investors could be an important source of private climate finance, as they already account for over 40% of the total portfolio debt outstanding in emerging and developing economies. But regulation now needs to be reviewed to facilitate cross-border flows of climate finance.

A potential forum for coordination

The new International Platform on Sustainable Finance, launched by the EU in 2019, could be one venue for coordination of climate finance regulation. In this forum, the EU partners with thirteen other economies, including key emerging markets such as China, India and Indonesia.

Potentially, and given that key jurisdictions are already represented, this group could play a central role in converging on common standards, for instance on disclosure or on the green labels used for financial instruments.

To date, the agenda for this group remains somewhat vague and has been limited to sharing and comparing national initiatives. Members of the group are likely to voice strong and disparate national interests, which will have to be reconciled:

- Among the five non-EU high-income countries in the group there will be interest in developing a local green

financial market place (eg. Singapore) and green banking standards (Switzerland); or in adopting strong environmental, social and governance (ESG) standards by portfolio investors (as promoted by Norway's large sovereign wealth fund).

- Two emerging markets participating in the Platform, China and Indonesia, are assessed as already having mature sustainable finance frameworks, including sustainability reporting requirements, green loan definitions, and a local green bond framework, similar to the provisions adopted in the EU.

- Several participants have developed independent green bond standards. China, based on its own taxonomy, accounts for more than two thirds of the green bonds issued by emerging markets in recent years. Indonesia and Chile have issued substantial amounts of sovereign green bonds in international markets in recent years.

- The group also includes smaller lower middle-income countries, including Kenya, Morocco and Senegal, where issuance of green financial products is developing within very limited local capital markets.

Despite its size — this group accounts for roughly half of global greenhouse gas emissions and about 45% of global GDP – the EU platform could become more representative. In early 2020, 25 countries were working on sustainable finance roadmaps, which may produce similar classification systems and standards for green capital market products.

These countries include key emerging markets such as Brazil, Nigeria, Mexico or Vietnam, who should be encouraged to join the EU platform. Crucially, the United Kingdom will now diverge from the EU in a separate regulatory regime, and should also be brought into the Platform.

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The EU's role

From the EU's perspective, an overriding ambition within the IPSF should be that a high standard for sustainable finance is protected internationally. This should address the risk that 'greenwashing' by individual issuers, fund managers or jurisdictions – the misleading disclosure to prospective investors or conduct by the borrower that deviates from initial commitments – could undermine the entire sustainable finance asset class.

Asset managers, in both retail and professional markets, should be offered transparent green finance products of a consistent high standard. This could replicate the success of other EU capital market standards, such as for retail investment funds.

At the same time, the EU should ensure that financial products that fund EMDE projects based on local taxonomies remain eligible for green funds structured by EU asset managers or for loan refinancing, making it consistent with open international markets for climate finance.

For instance, an EU registered fund marketed as low-carbon or 'Paris-aligned' under the new EU benchmark regulation should be able to include green bonds from a wide range of developing country issuers.

This should require that such issuers comply with EU standards for borrower disclosure and verification by accredited firms of the non-financial aspects in bond documentation, such as the use of proceeds.

Principles for coordinating cross-border flows

Coordination between central banks on supervision and stress testing are well under way within the Network for Greening the Financial System.

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In the EMDEs, and in particular in lower middle-income countries, national banking systems will remain the dominant source of climate finance, as the rapid expansion of capital markets or attracting international investors focused on ESG criteria are not realistic.

Agreement on green banking principles, which remain much more diffuse than in the capital markets space, are therefore essential. The IPSF could spearhead this initiative, thereby addressing the current lack of international coordination.

The IPSF could focus on three areas in particular:

- EU investors and cross-border banks will be bound by taxonomies that define green activities eligible for designated green financial instruments, and possibly for incentives.

  A comparison of such classification systems shows that the EU system is by far the most complex, setting metrics and thresholds for 70 climate mitigation activities and 68 adaptation activities. The Chinese system, by contrast, is much more general and does not include specific screening criteria.

  Developing countries will include local investment priorities (especially in climate adaptation) and local environmental issues, such as pollution abatement. There should be common design principles for taxonomies, though which activities benefit from incentives may well differ across jurisdictions.

- Disclosure by financial firms and their large corporate clients is a foundation for offering financial instruments with added green qualities.

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Implementation of the recommendations of the G20 Task Force on Climate Related Disclosure (TCFD) is weak among mid-sized companies and in emerging markets, as requirements for the measurement of environmental impact are rare in the real sector.

The EU directive on non-financial reporting, which is currently under revision, should define practical environmental reporting templates. The EU could support capacity building in large emerging markets implementing similar standards, and open the proposed EU repository for ESG data to private sector issuers of green bonds.

- Standards for the origination and labelling of green financial products. Given this greater transparency, green financial products can emerge that are readily recognised by investors.

  The future green bond standard, and the now adopted low-carbon benchmarks for investment funds are the key necessary pieces of EU legislation. Even though the market for green bonds and ESG funds has grown rapidly on the basis of private sector standards, regulation will need to address incentives for 'greenwashing' by debt issuers and investment firms.

  Emerging market issuers and fund managers should have the option of meeting the future EU green bond standard, including by working with locally accredited verifying agents, which are recognised by the EU as subject to equivalent supervision.

If the new IPSF is to become a real forum for common rule-making, the EU will need to contend with concerns in other jurisdictions that the EU framework has reinforced the fragmentation of global climate finance.

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Many of the partner countries represented in the platform and other key emerging markets now have credible sustainable finance frameworks of their own.

As the climate challenge is global, realigning financial flows also requires a coordinated response. The new EU forum should be as inclusive as possible. ■

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