UK PACT

Greening finance: Enabling financial systems that prioritise sustainable development

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Greening finance: enabling financial systems that prioritise sustainable development

The greening of financial systems creates enabling environments and universal standards to prioritise climate-smart outcomes. Early-stage results across the global UK Partnering for Accelerated Climate Transitions (UK PACT) portfolio are encouraging and indicative of the strong potential to achieve significant commitments on the subsequent mobilisation of finance for green outcomes.

Green finance refers to 'any structured financial activity – a product or service – created to ensure a better environmental outcome'. Green finance products include 'loans, debt mechanisms and investments that encourage the development of green projects or minimise the impact on the climate of more regular projects' (World Economic Forum, 2020).

A key difference between green finance and climate finance is that green finance includes 'financial investments into sustainable development projects and initiatives, environmental products, and policies' encouraging the development of a more sustainable economy' (IDFC, 2012). Climate finance is a subset of green finance encompassing local, national, and transnational financial flows seeking to address climate change (UNFCCC, 2021).

'Green finance' contains two categories:

1) Greening finance, or support in the greening of the financial system, which chiefly includes:

- Collaboration among financial regulators, project sponsors seeking finance, financial institutions, policymakers, trade bodies, think tanks, and multilateral organisations to achieve mutually beneficial outcomes;
- Awareness-raising activities of the financial sector's ambitions and achievements in green finance; and
- Commitments and strict adherence to compliance with and disclosure of information on progress towards green goals.

2) Financing green, or the mobilisation of public and private finance for clean and resilient growth, which chiefly includes:

- Introductions of pioneering and innovative financial mechanisms to fund green projects, including through a mix of funding sources as well as through the use of risk-mitigating tools (i.e., guarantees for credit enhancement);
- Exploration of ways to integrate green (often nature-based) solutions into traditional grey infrastructure projects.

Green finance, particularly the greening of finance, forms a significant part of UK PACT's work and is consistent throughout the global portfolio. The remainder of this brief will focus UK PACT's efforts towards greening finance.

Why does the greening of finance matter?

The goal of greening finance is to incorporate climate and environmental risks and opportunities in every financial decision. Transitioning to a green financial system implies a shift in decision-making processes across the economy, and it is fundamental to achieving the Paris Agreement.

Environmental, Social and Governance (ESG) investing references the guiding principles for green finance. Its mainstreaming has catalysed the incorporation of sustainability factors into investment decisions, including at the financial instrument level (S&P Global Ratings, 2021).

Further, finance theory and empirical evidence demonstrate that investors prefer 'green' over 'dirty' assets for financial and non-financial reasons, increasing the appetite for green instruments and investment opportunities (Troeger & Steuer, 2021).

There is a clear commitment, particularly from institutions with large amounts of capital to invest, to allocate more money to green finance opportunities. This year, Net Zero Asset Managers, an initiative representing 128 of the world's leading asset managers managing a total of USD 43 trillion, announced their collective commitment to 'reach net zero emissions alignment across their portfolio by 2050 or sooner and to set interim 2030 emissions reductions targets' (Net Zero Asset Managers, 2021).

However, greening finance goes beyond ESG. The shift in decision-making leading to green financial systems involves quantifying climate and environmental risks and opportunities. Yet, for stakeholders around the world, particularly in low and middle-income countries, there is a severe lack of information on how to define and invest in green finance opportunities.

According to the United Nations Environment Programme, financial institutions have struggled to quantify the upside opportunities for green finance, effectively assess the gaps and trade-offs between green and more familiar traditional investment opportunities, and overcome illicit practices and weak enforcement (UNEP, 2016). Information, capacity and tools are crucial for the financial sector to evaluate climate and environmental risks and opportunities and fully incorporate this evaluation in its investment decisions and products.

Furthermore, transparency around green financial products is essential. Greenwashing or making false or misleading claims about environmental practices, performance or products, which is a prevalent challenge for both investors and consumers, is very problematic. Generation Investment Management analysed and reported an overwhelming number (nearly 50 per cent) of websites making irresponsible, misleading or untruthful claims on their delivery of green commitments. The investment manager also advocates for clearer guidelines and safeguards to ensure accurate reporting on the achievement of green objectives (Generation IM, 2021).

Greenwashing can be problematic for investors. Institutional investors who have pledged to maintain a percentage of their overall allocation in green bonds can face problems if these bonds are non-compliant with green principles. For example, the Wall Street Journal has reported on bonds meant to finance environmental projects, but where the issuers do not need to guarantee that the money raised will be used for green purposes (Wirz, 2021). This dysfunctionality in adherence to green definitions can derail the goals set forward by financial sector initiatives.

Hence, clear and enforced definitions for green investments and accurate reporting on green products are critical to ensure that financial resources are allocated to actual green outcomes.

How is UK PACT supporting the greening of finance?

UK PACT's interventions in the greening of finance, designed together with partner country governments, aim to resolve the obstacles identified above with targeted support for partner countries' public and private sectors.

To support the public sector, UK PACT is helping partner countries create a coherent enabling environment that signals their commitment to green finance to the financial sector and encourages flows of funds to green investment opportunities through the use of reliable and internationally accepted concepts on disclosure and definitions, as well as clear commitments to and expectations on green goals;

Our private sector projects aim to increase the general awareness of financial institutions and companies about green finance and enhance the capacity of financial institutions to accurately consider investment opportunities that meet public-sector requirements for compliance with green definitions.

Public sector support

We build on reliable and internationally accepted frameworks to help partner countries strengthen their disclosure requirements and design their green investment definitions.

Improving climate disclosure

In its review on how the financial sector could take account of climate-related issues, the Financial Stability Board identified the need for better information to support informed investment, lending, and insurance underwriting decisions and improve understanding and analysis of climate-related risks and opportunities. The Task Force for Climate-Related Financial Disclosures (TCFD) is a response to this climate-related information need.

The TCFD developed four widely adoptable recommendations on climate-related financial disclosures that apply to organisations across sectors and jurisdictions (Task Force on Climate-related Financial Disclosures|TCFD, 2017):

- Adoptable by all organisations
- Included in financial filings
- Designed to solicit decision-useful, forward-looking information on financial impacts
- Strong focus on risks and opportunities related to the transition to a lower-carbon economy.

Adherence to the principles of TCFD has been more widespread in higher-income countries, and UK PACT is providing support to accelerate the adoption of TCFD and other global pacts on disclosure in the partner countries.

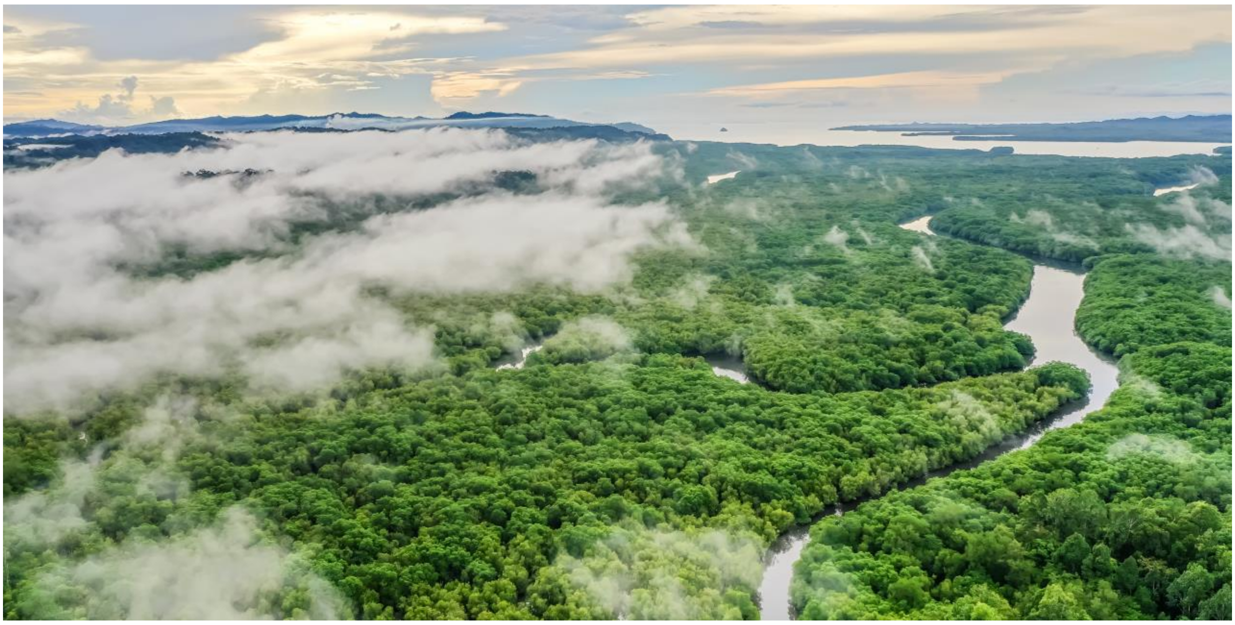
However, while compliance with and subsequent adherence to TCFD can be invaluable for tracking disclosure, there is a need for a more significant and deliberate commitment to any form of disclosure for many lower and middle-income countries.

In China, UK PACT is supporting CDP to increase the level of green decision-making by financial institutions through climate-related financial disclosure and transparency. Through its UK PACT project, CDP has, in conjunction with its local partners, been able to increase the number of companies reporting on climate-related issues by 44 per cent in a twelve-month window.

> **With the support from UK PACT, CDP has dramatically increased the number of companies and financial institutions reporting on climate in China. As a result of programme implementation in 2021, the number of companies in compliance has increased by 44%.**

This increase in disclosure has been achieved by building financial institutions' capacity to normalise the inclusion of climate-related disclosures in their investment assessment processes and identify opportunities to increase the flow of capital to climate-resilient projects. Over a longer period, this support can yield even greater results; as soon as China's mandatory disclosure policy is in place, financial institutions and project sponsors will be required to follow the methodologies introduced through this project. Further, this programme falls in line with announcements from the Chinese president, who has announced the 2060 carbon neutrality target that will further accelerate the process of low carbon transition in China.

Through the work of implementing partners, UK PACT has uncovered that many financial institutions, whether banks or asset managers, are reluctant to attempt compliance with international best practices of disclosure, such as the proposed by the TCFD.



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DNA Economics leads a consortium – working with Vivid Economics, The Green House, Six Capitals Advisory and World Wide Fund for Nature (WWF) South Africa— that developed a set of learning modules showing that compliance with disclosure expectations is part of a progression rather than a binary question of compliance or non-compliance.

> In South Africa, DNA Economics leads a consortium helping to future-proof the financial system by demonstrating the ease of compliance with internationally-acceptable disclosure norms.

The international best practice is to start reporting early and then increase the quality of disclosures over time. Research by the consortium showed that barriers to starting the disclosure journey in South Africa are lower than generally believed.

Furthermore, an analysis of 55 of the largest companies listed on the Johannesburg Stock Exchange (JSE) illustrated why disclosure is important. Transition risk could reduce the value of these companies between five per cent (if climate action is taken quickly) and close to eight per cent (if climate action is delayed) by 2050. The impact on companies in some sectors could be much larger - with companies in four sectors potentially losing a quarter or more of their value if business models are not amended. Over the course of the next five years, the consortium aspires to see more and better disclosure by key stakeholders across the financial spectrum in South Africa.

Using common definitions of green

Prominent members of the international financial community are collaborating closely with their public-sector peers to develop universally understood definitions of green finance – responding to the need for a common understanding of what is green. These definitions are manifested through guiding principles and taxonomies, many of which are modelled after international best practices.

Two of the projects with the greatest potential for long-term impact in this sector help to underscore the transformative effect of clear definitions and understanding of terms: the green taxonomy project in South Africa and the green bonds efforts in Colombia.

Funding from UK PACT is helping the National Business Initiative and the Carbon Trust to support the transformation of South Africa's nascent green finance taxonomy into a user-friendly set of definitions covering concepts of sustainable finance more broadly.

These efforts can help economic actors allocate capital more consistently with the vision for a development-focused, climate-resilient economy. In the long-term, the work under this project is expected to enable project sponsors and capital providers to design and implement strategies that will lead to financial flows delivering a higher degree of green-compliant projects. Encouraging the financial sector to implement the necessary re-alignments to meet requirements is the initial step to enabling these green-compliant financial flows. This re-alignment by investors will prompt project developers to focus on taxonomy-aligned projects. This alignment between projects and investors will ultimately lead to emissions reductions at scale as the taxonomically aligned project pipeline grows and sustainable finance increases.

To date, work on the green taxonomy has engaged 23 key organisational stakeholders, including 12 financial institutions and other intermediaries prepared to provide capital for shovel-ready projects.

In Colombia, the Climate Bonds Initiative (CBI) is working in partnership with Metrix Finanzas to support the development of Colombia's financial market through several activities.

CBI provides technical advisory to the Colombian Government on developing the Colombian Green Taxonomy, which establishes nationally adapted definitions for green finance. This advisory is complemented by capacity-building and technical assistance to four institutions keen to pilot the use of the local Taxonomy to raise funds for climate-aligned infrastructure projects in the Colombian capital market.

The team is also drafting the blueprint for a Sovereign Fund underpinned by the country's climate strategy that aims to attract capital to finance the Colombian green agenda and fund taxonomy-aligned projects.

Box 1. Implementing local green definitions to enable long-term investment into priority sectors in Colombia

In Colombia, the Climate Bonds Initiative has signed a Memorandum of Understanding with four creditworthy issuers who are looking to raise funds for climate-smart infrastructure in local capital markets in the coming months. Without CBI's support, there is a significant risk that these bond issuances would not comply with international standards for green bonds.

It is also critically important to note that UK PACT support has enabled the Climate Bonds Initiative to expand into Latin America, bringing their wealth of knowledge and experience from work across the global south for adaptation to the local context in new frontiers. The presence of Climate Bonds in the region helps key stakeholders in the financial ecosystem to identify the risks, benefits, and opportunities of climate-smart infrastructure investment.

Image: © Alex from the Rock

Private sector support

In working with the private sector, our portfolio focuses on raising awareness across financial institutions and companies about green finance and improving financial institutions' capacity to incorporate climate factors in their portfolios.

Awareness-raising for financial institutions and companies

The private sector generally embraces the concept of green finance within a broader set of policy goals and sees the prospect for investment opportunities in this emerging sector. However, financial institutions in middle and low-income countries are seeking more information about how to incorporate green considerations into their strategies, both internally and from an investment perspective.

UK PACT supports Mexico in its efforts to mainstream green finance by consolidating various climate finance efforts into the Green Finance Advisory Board (the Consejo Consultivo de Finanzas Verdes de México A.C., or CCFV).

To date, more than 1,300 financial professionals from institutions of all types and sizes have attended the courses and events developed through this initiative. Due to this level of attendance, more financial institutions are entering the ESG debate and are demonstrating interest in adhering to principles for sustainable finance, in addition to signing the declaratories created by the CCFV in previous years.

The Advisory Board's senior leadership expects that more financial institutions declare specific commitments to finance sustainable projects and that they adhere to universally accepted frameworks while increasing demand and pressure for issuers to use the same principles to disclose ESG information. Further, the public sector benefits significantly from the Board.

> In Mexico, more than 1,300 financial professionals from institutions of all types and sizes have learned how to mainstream green finance into their daily work.

The CCFV supports the regulators of the Mexican financial system as an observer and representative of the private sector in the CFS. Hence, regulators are influenced by the knowledge products, trainings, events, and courses developed by the CCFV and their allies. The CCFV expects regulators to develop a sustainable finance taxonomy that starts with a green focus, and significant regulation regarding ESG disclosure that considers the adoption of double materiality and the use of frameworks such as TCFD.

Incorporating climate-related scenarios into portfolio management

Many financial institutions have begun to adopt general strategies for green finance but are struggling to embed these ideas within their analytical teams as part of a more data-driven assessment process. International standards are constantly being upgraded and improved, and UK PACT is well-positioned to support the appropriate contextualisation of these tools within partner countries.

In Malaysia, WWF contributes to carbon emissions reduction by building the capacity of financial regulators and institutions and strengthening the integration of climate-related risks and opportunities into policies, decision-making processes and financial product innovations. Ultimately, these efforts will enable capital flows into low-carbon sectors.

Box 2. Harnessing green finance in Malaysia

WWF-Malaysia is an invited expert and observer of the Malaysian Joint Committee on Climate Change (JC3) subcommittee. As part of this role, WWF was the event partner and rapporteur of the JC3 Flagship Conference (23-25 June 2021), which hosted personalities such as Sir David Attenborough, Lewis Pugh, and key policymakers from the national government in Malaysia.

The Conference hosted Board members, CEOs, senior management, practitioners, and financial institutions' clients, investees, and other value chain players. With the support from UK PACT, WWF and its partner – the 2 Degrees Investing Initiative – presented in three sessions on day one of the conference.

The JC3 aims to strengthen the financial sector's capacity to manage climate-related risks, as demonstrated in a recent joint statement by the central bank and securities commission. With UK PACT's support, the 2DII and WWF are helping two major Malaysian banks apply climate scenario analysis using PACTA, a globally recognised tool developed by 2DII. These banks are at the final stage of evaluating their portfolio alignment with climate goals using PACTA – an exercise among the first of its kind in the country. The team expects the widespread adoption of climate-related risk management and opportunity methodology across Malaysia, matching an overall goal of accelerated finance flows for green investment opportunities.

In Colombia, the Universidad de los Andes has identified a different set of gaps: both in the awareness and capacity of the private sector in considering climate change and the interaction between public sector policymakers and private sector market participants.

> **A leading Colombian university is designing and implementing a pioneering curriculum for key public and private stakeholders understand and plan for climate transition risks, with a vision of the national roll-out of these modules across a broad cohort of higher-learning institutions.**

To help respond to this challenge, the university, and five partner institutions of higher learning, have designed a curriculum that brings theoretical and practical information to a mix of learners in a mixed virtual/in-person classroom setting. Originally designed for 80 participants, the pilot cohort includes 97 students due to overwhelming demand, representing seven public institutions and 26 private sector companies. In this pilot phase, the university deliberately selected the insurance industry, which has a high sensitivity to climate risks, as part of the learning experiment to explore the transferability of learning between the public and private sector.

The project team is meeting its goals of improving knowledge and raising awareness on climate transition risks through a combination of applied research and training in their curriculum. The long-term outcomes are particularly encouraging: better preparedness for climate shocks and, ultimately, the achievement of long-term climate goals.

The team is already planning on replicating the curriculum at universities across the country to ensure that key national and subnational level decision-makers are well-prepared to respond to climate concerns and create an enabling environment that allows for innovative solutions.

Key recommendations

Each partner country is at a different stage in its green finance journey. Accordingly, UK PACT collaborates with national governments and local experts to ensure that targeted support is designed to deliver their needs and ambitions.

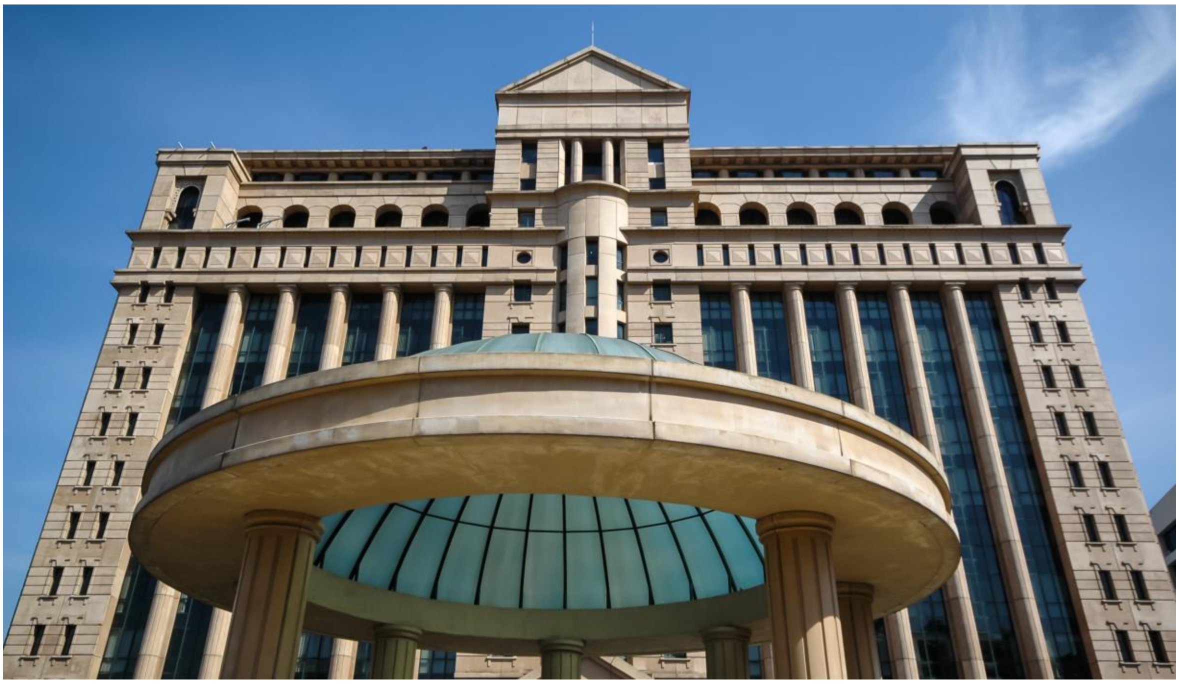
1. The examples highlighted throughout this brief evidence that support can and should be tailored and delivered to public and private sectors, as they have different capacities and needs. UK PACT adapts its support to each partner country by assisting in developing taxonomies and definitions, contextualised best disclosure practices, and creating local centres of excellence to disseminate knowledge on green finance.

   Furthermore, we support private sector stakeholders through general awareness-raising activities on the impact of green considerations in finance or specific assessments and tools on the opportunities and risks in climate finance.

   Regardless of the form of support offered, UK PACT aims to work in tandem with its partners to ensure that all initiatives in green finance are beneficial domestically and in line with global efforts to achieve more sustainable outcomes.

2. General awareness-raising activities should bring together both public and private sectors to accelerate the transition to a green finance system. Efforts to get numerous actors to understand climate transition risks and opportunities for the financial sector from a public and private perspective are needed from an early stage to make better decisions in line with the challenges and needs of each sector. Also, involving academic institutions in the process helps develop effective and practical learning methodologies, and provides the opportunity to escalate the awareness and knowledge at local levels.

3. Institutional regulations and government commitments, such as mandatory disclosure policies and the definition of Green Taxonomy adapted to the country but in line with universally understood definitions, together with self-regulation from the private sector, are crucial to increasing the level of green decision making in the financial sector and transparency.



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