Five years later, are we serious on aligning private financial flows?

By Santiago Lorenzo

When reading the news about the economic health of a nation, a region or the world, the main relevant information and data found is financial. The global financial ecosystem, including the largest banks and institutional investors, are perceived as the most serious in the way they interpret market signals and carry on their economic analysis. However, the reality is that today, they live-in wonderland, a fictional world.

A deeper analysis shows that the multiple crisis, partly exposed by the Covid19 pandemic, are unequivocal signs of an exhausted economic system[1]. The immediate evidence is how neglected are basic public services[2] – as health, unemployment support. Going beyond the immediate are other potentially deeper crises being developed. One, has been named as a cause of the pandemic, the destruction of biodiversity – known a long time ago as a potential threat to humankind[3]. Another, climate change, is a potential cause for the next pandemic[4], has also been neglected, even after the Paris Agreement[5].

Financial institutions assess their business scenarios with XX Century mindsets. Most of them think their profit-seeking strategies are safe by hedging, holding a wide portfolio that includes oil and gas, beach resorts, cement, agriculture, steel and fisheries, among many other assets. The same scenario is applied to the whole set of assets.

It seems that they refrain to go deeper when reading or watching the news. The dominant business of the nineteen-nineties (top in Forbes list at that time) are not the ones of today. We are in an accelerated industrial revolution, in part triggered by climate change, which at the same time is the cause of many of the extreme weather events also shown in the news. Connecting the dots, it is clear than climate-related transition and physical risks[6] are already here since some years ago.

The real scenario is that climate-related financial risks have the potential to be devastating for the economy and, particularly, to the financial industry[7]. Both kind of risks demand a serious assessment on how delaying climate action will not save high GHG emission intensity sectors, but are increasing exponentially the risks in other assets highly vulnerable to climate change impacts.

The Financial Stability Board (FSB) report back to the G20 Ministers of Finance was a colossal market signal for all financial institutions to start taking climate-related financial risks seriously, Reinforcing this signal, in the same year – 2015 - the international community reached the Paris

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1 https://www.downtoearth.org.in/blog/climate-change/multiple-crises-the-cost-of-wasted-time-71508
2 https://www.theguardian.com/commentisfree/2020/may/16/state-intervention-agenda-dont-assume-neoliberalism-dead
3 https://www.greenfacts.org/en/global-biodiversity-outlook/l-2/1-biodiversity-loss.htm
4 https://www.scientificamerican.com/article/deep-frozen-arctic-microbes-are-waking-up/
5 https://urgewald.org/five-years-lost
6 https://www.fsb.org/2015/11/disclosure-task-force-on-climate-related-risks-2/
7 https://www.ngfs.net/sites/default/files/medias/documents/ngfs_first_comprehensive_report_-_17042019_0.pdf

Agreement[8], the UN Sustainable Development Goals[9] and the Addis Ababa Action Agenda[10] for Finance for Development. These advances sat a new landscape for economic development all around the world, and thus, for investments.

Particularly in the climate agenda, in addition to these markets signals and going beyond the daily news, the IPCC[11] has made the scientific case for increasing attention by investors on climate matters through their amazing work describing the climate scenarios and their economic consequences.

For climate action, private finance is important as all activities (public and private) need to be aligned with climate objectives. However, we need to be clear here. As public good the atmosphere must be supported with public finance to maintain its best conditions for humans and nature to thrive. In this regard, and due to the UN Principle on common but differentiated responsibilities, the bulk of the negotiations in the UNFCCC refer to public financial resources committed by the developed countries to support climate action in the developing world.

Public finance – as addressing climate change is of the utmost importance for governments – should be the first in aligning their operations with the Paris Agreement goals. However, we are far from it to happen[12]. Furthermore, in most developing countries to rely in their own public finance is a mirage, as the fiscal space for pouring public money to any kind of public good is tight or inexistent[13]. The current sovereign debt problem[14] is the most notorious symptom of the absent fiscal health in most of these countries. This problem is due to a post-colonial financial architecture – including tax havens, but not limited. This is a key issue that deserve its own chapter.

While public money should be already aligned with the multilaterally agreed climate goals, private finance for its own sake should follow. However, this is not happening. One example on how private finance is not walking the talk can be shown by the following data[15]. In 2019, only 35% institutional investors and asset managers are reducing exposure to fossil fuels; 40% take climate issues into account in financial decisions; 17% integrate climate into their asset allocation and 15% set climate related targets. In the case of banks, 51% offer green financial products; 53% have processes for managing climate-related risks: 64% disclose their carbon footprint; 31% measure the climate impact of their financing activities and 38% conduct climate-related scenario analysis. These are numbers showing insufficient progress to address a changing environment for the financial business, even worst thinking in the real climate emergency we are facing. Four years after the key multilateral moment of 2015, described above, with climate physical impacts

[8] https://unfccc.int/sites/default/files/english_paris_agreement.pdf
[9] https://sdgs.un.org/es/goals
[10] https://sustainabledevelopment.un.org/index.php?page=view&type=400&nr=2051&menu=35
[11] https://www.ipcc.ch/sr15/
[12] https://bigshiftglobal.org/finance-common-missed-opportunity-leadership-and-ambition-climate-and-energy
[13] https://www.fitchratings.com/research/sovereigns/global-sovereigns-face-limits-to-fiscal-space-10-03-2020
[14] https://www.imf.org/en/News/Articles/2020/11/16/vc111620-current-sovereign-debt-challenges-and-priorities-in-the-period-ahead
[15] https://www.climate-chance.org/wp-content/uploads/2020/10/global-synthesis-report-on-climate-finance-2020-complete-climate-chance.pdf

estimated in US$ 3.6 trillion in economic losses[16] (over the past 50 years), and strong signals of the materialization of transition risks[17], the financial sector, one of the wealthiest in the world, is not investing in their own business interest. Worrying!

In a way, despite being a matter of financial risk and opportunities, the XX Century thinking of all green and sustainable issues identified as a marketing topic has not yet abandoned the highest ranks of financial decision making. BlackRock CEO letter from the beginning of 2019 was praised as a turning point, one year later, it has become smoke. They continue on "business as usual" mode[18], despite their alleged commitment with climate action. Many members of the sustainability progressive UNEP FI Principles for Responsible Banking are among banks signaled as contributing to Amazon depletion (promoting devastating illegal deforestation[19]).

After the work by the FSB and the Task force on Climate-related Financial Disclosure (TCFD), among massive literature on the importance of environmental and climate related financial risks, what part of it has been lost for financial institutions? Dealing with these risks is not a fancy, millennial fashion, it is about survival in the market.

Despite that "…there is hope in the next generation of investors. *The Economist* recently highlighted that 87 per cent of young investors believe corporate success should be measured by more than financial performance. They want a viable planet that can sustain them and generations to come"[20]. The ecosystems health may not be so patience to wait for the new generation of investors to reach the high influential level to decision making.

As an overall diagnosis, we could say that private finance is moving in a very slow pace on climate issues, there is still a lot of simulation and total lack of investments in their own sustainability teams and the tools required for identifying, measuring, analyzing and managing these risks (and opportunities). The TCFD guidelines[21] promote mainstreaming, but so far has been insufficient.

To a better understanding on the whys, a key issue is that scientific knowledge and the overwhelming evidence of climate change is being eroded by a kamikaze denialism and the uncertainty on decisive climate action by governments. After reaching the Paris accord, many governments had step back. The financial system somehow is quite neutral, if NDC pointed out towards a 1.5ºC; all public policies were aligned with the SDGs and the Paris Agreement objectives and financial regulators impulse the adequate processes to stage climate stress test in the short term, all financial institutions would be more active in mainstreaming climate in their operations. Besides Governments properly regulating financial markets in climate-related issues, they also

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16 https://public.wmo.int/en/media/press-release/state-of-climate-services-2020-report-move-from-early-warnings-early-action
17 https://www.theguardian.com/business/2021/jan/27/rating-agency-sp-warns-13-oil-and-gas-companies-they-risk-downgrades-as-renewables-pick-up-steam
18 https://prospect.org/environment/blackrock-s-greenwashing-threatens-undermine-climate-action/
19 https://www.globalwitness.org/en/press-releases/major-global-banks-complicit-widespread-destruction-amazon-rainforest-linked-brazilian-beef-companies-and-international-audits-flawed/

20 https://www.telegraph.co.uk/business/how-to-be-green/post-covid-environmental-changes/
21 https://www.fsb-tcfd.org

need increasing involvement in generating the adequate climate / environmental data packages for financial decision making.

In this regard, what could COP26 do to accelerate the adoption of climate policies and criteria by private financial institutions? What are the limits for COP26 to decide on finance? Is there a single better platform for engaging private finance in pursuing a global common good?

The UK COP 26 Presidency shaped its approach for climate & finance with the document "Priorities for public climate finance in the year ahead"[22]. In its point #4 requiring attention by the international community is "Mobilized private climate finance" stating that "How the international community engages the financial sector to allocate capital to manage physical climate risks and seize opportunities in the transition to net zero will be critical". Indeed, governments still had to walk to foster the financial transition required, as mentioned above.

However, financial institutions themselves still can walk the talk and be more instrumental in preparing their business for the changing landscape due to climate change. In this regard, inside their competitive environment, there is space for collaboration in advancing the development of data and tools collectively. Different initiatives already exist but further coordination would be very welcomed. In this regard, the initiative for a Glasgow Private Finance Accord (GPFA[23]) is interesting and requires clarity to guarantee it will add value to the existing frameworks.

The Paris Agreement did not develop the institutional architecture for the private role for the financial objective. An accord, such as the GPFA, will need some architecture to promote enabling environments. But let's be clear on what enabling environments must mean. The term has a bad press because "enabling environments for investments" historically had meant a push for privatization processes. That is a historical reality. And we have witnessed during the covid-19 crisis that privatization, sometimes, at least in public health but not limited, has been a disaster. So, it is required to open the definition to a wider meaning, "enabling environments" is not about privatization. It is about framing policies influencing investments to achieve a collectively desired objective. In this case, making environmental sustainability (and particularly climate solutions) easier for investments than the catastrophic business as usual. These investments can be public or private, it is about making all economic activities much greener.

In this GPFA, regulators should participate along with public finance institutions to foster real progress. The NGFS and the Coalition of Finance Ministers for Climate Action have a big task on enhancing the good job that they are already developing. Much more compulsory measures and less voluntary initiatives, because we need action now. Governments should invest in developing green assets, sustainable infrastructure and solution side start-ups, sustainable cities and communities, etc. The financial sector for greening their portfolios, need an increasing number of such assets to avoid any potential of green asset financial bubble, with large amounts of money going to limited number of assets.

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[22] https://2nsbq1gn1rl23zol93eyrccj-wpengine.netdna-ssl.com/wp-content/uploads/2021/01/PRIORITIES-FOR-PUBLIC-CLIMATE-FINANCE-IN-THE-YEAR-AHEAD.pdf
[23] https://climatesan.org/share/GlasgowPrivateFinanceAccord-final-by-Aviva.pdf

Nonetheless, the workload of such a platform, of course, is on the side of private sector financial institutions. In the GPFA, besides what is already stated on the Aviva proposal, they should agree on investing in their own capacities, in avoiding greenwashing, in lobbying their governments for accelerating the advance in the regulatory framework required, in collaborating with the pertinent authorities and research organizations in shaping new relevant data packages, in enhancing efforts to match the transitional scenario with the physical scenarios, to reflect progress made in the financial sector in the NDCs (setting ambitious targets), among other potential outcomes.

Being this Accord coordinated with the UNFCCC process could help a better understanding with the authorities developing NDCs. The issued NDCs were developed by countries' governments according to a static scenario on the financial side. The high emitters industrial sectors were reluctant to take action, based in the usual financial conditions. But once premium loans reward the ecological transitions that reduce risks, there will be incentives for climate action and will be reflected in the NDCs.

We know that financial markets not necessarily follow environmental agreements, but in the UNFCCC many decisions are impacting the real economy, and the bridge between both worlds is of the utmost importance. The proposals of further engagement by private finance in the climate talks (be the proposed Glasgow Private Finance Accord or any other) is key for successfully achieve the Paris Agreement objectives (and the SDGs). Key will be not to duplicate existent initiatives, but support them and adding value.

A final world, such a private climate finance umbrella initiative must not distract us from the importance of transferring public finance from developed to developing countries. Climate change was generated by a few and the most – not responsible for the problem- are paying the most.