Green Finance

Key Business Considerations for Financing a Sustainable and Low-Carbon Economy

BIAC Discussion Paper – June 2016

Introduction

The adoption of the Sustainable Development Goals (SDG) and the Paris Climate Agreement in 2015 has paved the way for the integration of increasingly sustainable approaches into future business models, including in the financial sector.[1] For example, the Addis Agreement (2015) commits countries to *"endeavour to design policies, including capital market regulations where appropriate, that promote incentives along the investment chain that are aligned with long-term performance and sustainability indicators".*[2] Similarly, the Paris Agreement (2015) commits signatories to make *"finance flows consistent with a pathway towards low greenhouse gas emissions and climate resilient development".*[3]

The financial sector can support the transition to a sustainable and green economy in several ways. Investors are already moving towards greener and low-carbon investments, with the share of private sector investment in green finance rising by 26% from 2013 to 2014.[4] Broader sustainability criteria are increasingly being incorporated into investments. Financial markets and infrastructure can also help to provide pricing and tradability of carbon risk, as well as helping to manage climate risk through insurance and financial instruments to hedge these risks.

While there is a lack of an internationally agreed definition of green finance, for the purpose of this paper we refer to green finance in the broader sense, from financial initiatives and processes designed to promote environmentally sustainable investments across financial asset classes, to specific products and services that seek to promote environmentally sustainable investments – including energy sources, low-carbon technologies, products, projects, industries, and businesses.

Future investment needs for a low-carbon future are enormous. For example, the International Energy Agency (IEA) estimates that by 2035, a cumulative USD 48 to 53 trillion need to be invested in strengthening energy supply and energy efficiency.[5] A number of INDCs submitted to COP21 include

[1] See also the July 2015 *Addis Ababa Action Agenda* agreement on the key role of ODA and private sector green finance in development financing. http://www.un.org/esa/ffd/ffd3/wp-content/uploads/sites/2/2015/07/Addis-Ababa-Action-Agenda-Draft-Outcome-Document-7-July-2015.pdf

[2] United Nations (2015) Addis Ababa Action Agenda of the Third International Conference on Financing for Development, Section B, Domestic and international private business and finance, p38.

[3] United Nations Framework Convention on Climate Change (2015) Adoption of the Paris Agreement, Article 2 (1) c, Conference of the Parties, p21.

[4] CPI (2015), Global Landscape of Climate Finance. http://climatepolicyinitiative.org/wp-content/uploads/2015/11/Global-Landscape-of-Climate-Finance-2015.pdf

[5] IEA (2015), World Investment Outlook. https://www.iea.org/publications/freepublications/publication/WEIO2014.pdf

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ambitious targets requiring major investments that will depend on private sector finance. Meeting these investment objectives necessitates not only active private sector participation, but also an enabling policy and regulatory framework to incentivize and support private sector financing for the transition to a low-carbon economy. High-level efforts are therefore underway, such as the creation of a new industry-led disclosure taskforce on climate-related financial risks by the Financial Stability Board (FSB), and the G20 Chinese Presidency prioritizing green finance as a top agenda item.

As a contribution to possible OECD activities and discussions in the area of green finance, BIAC is pleased to provide key business considerations relating to a predictable and coordinated regulatory approach, supervisory assessment and understanding of financial risks, the crowding-in of green finance, definitional and methodological issues, export credit guidelines, and legal frameworks.

Predictable and coordinated regulatory approach

Private finance sources will be essential to addressing climate change as well as other sustainability challenges. For this to happen, in addition to the availability of capital, private sector investment depends on an assurance that the policy environment is stable and predictable so that investors can be certain that policy goals and incentives will be in place for the duration of projects. In this context, BIAC strongly supports the OECD Policy Framework for Investment (PFI), which offers guidance, including in the areas of finance and investment in support of green growth, to help governments create the right conditions to attract domestic and foreign investment.

Policy and regulatory frameworks for green financing are in many respects similar to the enabling environments required to generate investment in general. Investors – whether banks or other types of financial institutions – are unlikely to commit the long-term financing required for green investments if there are constantly changing regulatory goalposts, and where the risk-return of the investment may be very different at the conception and planning stage, and during the project life cycle. Ensuring appropriate, predictable and stable policy and regulatory environments is therefore essential for investor confidence in the long-term. Where policy changes are contemplated, adequate transition time and a participatory dialogue process needs to be provided for businesses to adapt accordingly. Additionally, the retroactive application of regulatory changes should be avoided and policymakers should maintain a level playing field between public and private entities

Discussions on attracting green financing cannot ignore the consequences of recent and ongoing regulatory processes. The possible unintended and cumulative impacts of financial regulatory measures on private industry participation in green financing should be examined through an equal focus on financial system stability, the green growth agenda, and return on investment. Business therefore encourages a holistic perspective that includes both finance and investment policies in order to scale-up green finance, as varying policy domains "have to date functioned quite separately and sometimes at

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cross-purposes".[6] As highlighted by BIAC and B20 Turkey in 2015, increasing regulatory coordination should be an overarching priority.[7]

Supervisory assessment and understanding of financial risks

Central banks have started to focus on the impact of climate change on financial stability, by exploring how climate risks and other environmental risks may pose significant costs, volatility, and disorderly market transitions to both the financial sector and broader economy. There is also growing recognition that monetary policy operations can in some cases impact on the deployment of capital for the low carbon economy.

Financial regulators have started to examine other issues, such as how climate factors can influence the prudential risks in the banking sector, how the insurance sector could be impacted by climate change through increased likelihood of natural disasters, how investments and returns could be impacted by the transition to a low carbon economy, and how securities markets could be impacted by the disclosure of risks facing companies as a result of environmental challenges.

A core role of supervisors and regulators in green finance should be to help assist a managed transition to a low carbon economy that ensures minimal market disruptions, while also considering the other market and regulatory challenges that firms face (see previous section). Internationally-coordinated action and guidance is important in this regard, whereby each national central bank and regulator should ensure they have an appropriate understanding of the risks to their financial markets.

Crowding-in green finance

To help mitigate risk in environmentally sustainable and low-carbon markets, the public sector can play a key role in supporting the effective mobilization of private sector sources of green finance. Public support should therefore be encouraged to "crowd-in" private finance, through for instance the greater involvement of national development banks and use of concessional loans[8], which would reduce investment risk and shape investment trends.[9] Considering the breadth and depth of development banks' expertise in infrastructure, they can play a key role in addressing fragmentation of the infrastructure market by sharing knowledge and best practices. Development banks can facilitate the development and packaging of large scale projects, and reduce associated political and financial risk, such as through the introduction of a quality assurance scheme. But for this to happen, development banks need to not only respond to the needs of governments around the world, but also follow to the leads of private investors who may also help to identify viable projects.[10] More synergy between ODA,

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[6] OECD (2015), Mapping Channels to Mobilise Institutional Investment in Sustainable Energy. http://www.oecd.org/g20/topics/energy-environment-green-growth/mapping-channels-to-mobilise-institutional-investment-in-sustainable-energy-9789264224582-en.htm
[7] BIAC-B20 Turkey (2015), Business access to global value chains and financing SMEs.
[8] This approach is for example taken by the EIB.
[9] CPI (2012), Effective Green Financing: What have we learned so far?. http://climatepolicyinitiative.org/publication/effective-green-financing-what-have-we-learned-so-far/
[10] Arezki, Bolton, Peters, Samama, and Stiglitz, From Global Savings Glut to Financing Infrastructure: The Advent of Investment Platforms (February 2016). IMF Working Paper No.16/18

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ECA-covered financing and private investment is necessary and has to be strategically positioned to be correctly implemented in the long run. The investment requirements in green infrastructure and green energy are huge, and more partnerships and synergies between the different actors are required to ensure future success and sustainability. The provision of a reliable legal framework, and domestic policies to provide incentives for emission reduction activities, are necessary to ensure that private investment in new technologies and capacities, including financing in the long-term, is feasible. Feed-in tariffs (e.g. GET Fit Programme) can provide support to newer technologies, with market mechanisms giving a longer term framework. Business supports instruments like the "value for money" thinking implemented by World Bank and other donor agencies as key to not only promote green financing, but also to have sustainable projects overall.

Making use of securitization techniques such as collateralized bond obligations (or CBOs) or collateralized loan obligations (or CLOs) can also allow for better price discovery which could enhance the efficiency of the market and allow for a more effective pooling of risk, thereby encouraging private finance.[11] Recognizing the high cost of capital required for many energy projects, these instruments can help the private sector to optimize financial structures and promote financial innovation, thereby reducing the overall cost for low-carbon investments while improving their risk-return profiles.[12]

Definitional and methodological issues

While the Paris Climate Agreement was widely applauded as a major achievement, four key components require further consideration to fully enable private sector engagement in green finance:

- Firstly, there is a lack of a globally agreed definition on green finance. Such a definition could be important for promoting internationally consistent policy and regulatory approaches – essential for scaling up investment in technologies, infrastructures, and companies for greener growth.[13] Clarification of definitions, and improved coordination for the certification of "green" activities, would also provide more impetus to innovation and financial instruments such as green bonds.

- Secondly, while Paris was a step forward, countries now have to achieve successful implementation of NDCs. To do this effectively, investment and action should be targeted to areas in which the most reductions can be made at the lowest cost. Identifying these opportunities will require new models relating emissions to investment, improvements in transparency and updated information, and the presence of comparable incentive schemes and market mechanisms in all countries.

[11] OECD(2015). Infrastructure Financing Instruments and Incentives. http://www.oecd.org/finance/private-pensions/Infrastructure-Financing-Instruments-and-Incentives.pdf
[12] Breugel (2015), European Climate Finance: Securing the Best Return http://bruegel.org/2015/09/european-climate-finance-securing-the-best-return/
[13] OECD Series on Green Finance and Investment. http://www.oecd-ilibrary.org/environment/green-finance-and-investment_24090344

- Thirdly, emerging climate change reporting schemes would benefit from increased consistency and coherence as well as broadly accepted accounting and disclosure methodologies.[14] Some believe that it could prove useful for financial institutions, public sector entities and businesses to routinely measure the impacts of their investments from a Sustainable Development Goals (SDG) perspective. This could help private finance to develop more effective indicators which can assist them in improving business performance while meeting the objectives of the SDGs.[15] Additionally, increased disclosure and transparency has the potential to improve climate resilience across the network as a firm discovers and internalizes costs and benefits from upstream and downstream partners.[16] It is imperative to work towards comparable information, which will also require concerted action to reap benefits of climate change disclosure.[17] In addition to disclosing information about green financing risks, more information about trends in current and projected volumes of green finance could help to catalyse additional financing and investment. BIAC members therefore encourage further OECD work on tracking private climate finance flows.

- Fourthly, data on risk and other due diligence variables will be required by private finance. This particular type of data for green financing may not be easily available. More effort needs to be put into connecting some corporate management teams with the risk-modelling capabilities of some investors – such as the insurance industry, which has the capacity and experience to model and price risk. Different sectors within the business community are adding significant value in their respective domains. Adding to the aforementioned expertise of the insurance industry in pricing risk and supporting both adaptation and mitigation goals, the banking and financial sector continues to create and improve innovative financing mechanisms to underpin the Paris Agreement outcomes. A knowledge exchange network bringing together a cross-section of business stakeholders and researchers could add significant value in this area.

Address market distortions

There are differing views on the issue of carbon pricing, yet there is a basic need for business everywhere to operate in a stable and predictable policy environment. While there is currently no global carbon market, there is a recognized need to develop robust methodologies and establish a fair and transparent mechanism to provide reliable sources of green finance and incentivize decarbonisation. The overarching priority for policymakers must be a level playing field for businesses operating in competitive global markets. In countries and regions introducing emissions trading systems and carbon

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[14] Chartered Institute of Management Accountants (2010), "Accounting for climate change How management accountants can help organisations mitigate and adapt to climate change" http://goo.gl/Eb9nfJ
[15] UNEP (2015) Inquiry Report "THE FINANCIAL SYSTEM WE NEED: ALIGNING THE FINANCIAL SYSTEM WITH SUSTAINABLE DEVELOPMENT" http://web.unep.org/inquiry/publications. Also see KPMG (2015) SDG Industry Matrix https://www.unglobalcompact.org/docs/issues_doc/development/SDGMatrix-climate-extract.pdf
[16] ACCA Global, "Bursting The Carbon Bubble". http://www.accaglobal.com/gb/en/discover/ab-articles/corporate-reporting/bursting-bubble.html
[17] CDSB (2016) report on environmental reporting by FTSE 350 companies. http://www.cdsb.net/comply-or-explain-review-ftse-350-companies%E2%80%99-environmental-reporting-annual-reports

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prices, business stresses the need for a predictable policy environment. Existing mechanisms and legislation need to be taken into account to avoid market distortions for businesses already working with national or regional carbon pricing systems. It is also crucial to consider the cross-border nature of financing and business, and thus a global level playing field should be promoted across international markets.[18] There are many forums and opportunities to exchange information and best practices on market mechanisms, including the OECD and the G20. The OECD should continue to support work to link existing carbon pricing mechanisms, reflecting the outcome of the Paris Agreement, notably Article 6, which encourages cooperative approaches between Parties. Progress on this would help the development of a level playing field for businesses operating in competitive global markets.

Sustainable lending practices in export credit guarantees

Export credit agencies in OECD countries have committed to not providing coverage/loans to public entities and buyers in heavily indebted poor countries in situations where there is no appraisal from the World Bank or the IMF, or where there is no linkage to a grant element or official development assistance, as per the *2008 OECD Principles and Guidelines to Promote Sustainable Lending Practices in the Provision of Official Export Credits to Low Income Countries* (hereinafter called "sustainable lending guidelines"). This results in loss of opportunity for enabling economic development in heavily indebted poor countries, as green growth investments are eschewed in favor of more carbon-intensive alternatives to support growing energy and infrastructure needs. Moreover, some IMF and/or World Bank member countries are not complying with the sustainable lending guidelines, leading to competitive distortions.

BIAC calls for a revision of the sustainable lending guidelines, with a view to provide greater possibilities for commercial loans accompanying the respective products/projects. This should be feasible for projects which are classified under the 2014 Sector Understanding on Export Credits for Climate Change Mitigation and Adaptation, Renewable Energies and Water Projects (CCSU), or investments in infrastructure.

Clarifying the legal framework to mobilize investment by pension funds

Mobilizing the trillions of dollars held by pension funds will be crucial to funding sustainable development. However, despite a number of legal reviews that support the integration of environmental, social and governance (ESG) issues as being consistent with fiduciary duty, there remains a prevalent misconception that including ESG issues in investment decision-making conflicts with the fiduciary duty of an investor. In addition, there is confusion over the applicability of these fiduciary duties to all actors along the investment chain, including investment consultants and advisors. The resulting situation acts as a barrier to the consideration of ESG in investment decision-making.

[18] WBCSD (2015), Eight things your CEO needs to know to engage and shape carbon pricing. http://wbcsdpublications.org/project/eight-things-your-ceo-needs-to-know-to-engage-and-shape-carbon-pricing-policies/

More work is therefore needed at the international level to provide legal clarity around fiduciary duty. BIAC welcomes the OECD's current stock-take on governance and integration of the current framework and how it is used. Looking ahead, BIAC encourages the OECD to undertake further work that would consider how greater clarity could be provided so that pension funds can consider ESG factors when making investment decisions.

What role for the OECD?

For many years, the OECD has been actively involved in climate and green growth discussions related to finance issues, providing cutting-edge and timely analysis, most recently through its climate finance report for COP 21. Beyond global climate discussions, the OECD has also played a key role on broader financial issues through its Green Investment Financing Forum as well as work on financial institutions and instruments, such as green investment banks and green bonds.

We believe the OECD can add significant value in the following areas:

- Advise governments in the development of an enabling environment for the private sector to engage in green financing, with a particular focus on internationally coordinated and conducive financial regulatory frameworks,
- Continue the pioneering work on tracking climate finance flows and build on the OECD's work on the green growth indicators,
- Work with other international organizations to develop internationally consistent disclosure and reporting frameworks that include recognized accreditation and benchmarking standards,
- Increase understanding and awareness of green finance among all stakeholders, including in the public sector and in education systems,
- Incorporate country-specific socio-economic and developmental needs while supporting governments in achieving their NDCs and climate change goals, with a focus on cost-effective access to clean energy, and
- Ensure that potential progress in standardization of definition, indicators and procedures does not end up in strict and inflexible regulations that could become an obstacle to private finance agreements.

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