Creating stronger financial market incentives

Background Note[1]

Introduction – The need for climate action

Private finance has a vital part to play in the shift to a greener, more resilient economy and a fair transition for society: helping all companies realign their business models towards net zero and sustainability goals; funding transformative technology and innovations; and turning the billions committed to climate investment through public channels into trillions of total climate investment. To unlock this potential, we must focus on building the right tools, frameworks and markets so that the financial sector can both manage the risks and seize the opportunities in the transition to net zero, and in so doing, mobilise capital across the whole economy towards these ends. This will be crucial to meeting Article 2.1c of the Paris Agreement: making finance flows consistent with a pathway towards low greenhouse gas emission and climate-resilient investment.

Recent years have seen significant momentum to align financial flows with the Paris goals, driven in large part by voluntary action in the private sector. Financial institutions and corporates alike are adopting increasingly sophisticated tools to measure and manage their exposure to climate risk, including through the framework developed by the Task Force on Climate-related Financial Disclosures. Efforts are also underway to improve the measurement and reporting of the environmental impact of financial activity. In April, financial institutions representing $70 trillion of assets came together to form the Glasgow Financial Alliance for Net Zero, which will promote congruence across the global financial ecosystem – aligning ambition and action consistent with a pathway to achieve net zero emissions by 2050.

Efforts by financial institutions to "first, do no harm" and shift finance *away* from carbon-intensive business-as-usual need to be accelerated, and supported by the continued development of robust methodologies and data. At the same time, these efforts must be matched by parallel efforts to direct finance *towards* investment in the transition. The global financing gap associated with a 1.5 °C pathway remains huge, with annual energy-related investments having to increase by $3 trillion globally, the majority taking place in the developing world. The benefits associated with such a pathway go well beyond climate and include an added 4% to global GDP by 2030 alongside other socioeconomic, health and environmental benefits[2]. With overall investments in recovery and transition having to increase by around 2% of GDP to 2030[3], a substantial reorientation *and* increase in global financial flows is needed to fund the investment required to meet the Paris mitigation and

[1] Prepared by an informal working group including staff of international organizations, led by the COP26 Private Finance Hub.
[2] https://www.iea.org/reports/net-zero-by-2050
[3] https://www.lse.ac.uk/granthaminstitute/publication/g7-leadership-for-sustainable-resilient-and-inclusive-economic-recovery-and-growth-summary-report/

adaptation goals and the SDGs. Failure to reorient and scale up these flows will lock in future emissions, creating a risk of stranded assets, with consequent economic losses as well as financial stability risks, whilst leaving critical investment in adaptation and resilience underfunded.

The financing needs in emerging markets and developing economies (EMDEs) are particularly acute. While public finance will play an important supporting role, meeting the needs of EMDEs – who will account for two-thirds of global infrastructure investment to 2030[4] – will require public financial institutions and other actors to more effectively crowd-in private finance, including by connecting available capital with investable projects and encouraging new market structures. Alongside this, support for improving investment environments and the pipeline of investable opportunities in EMDEs will be critical.

A comprehensive strategy

At the broadest level, the objectives for finance are therefore twofold:

1. to shift finance flows away from business-as-usual[5], including through commitments and tangible steps taken by all financial institutions to ensure their activity is aligned with the Paris goals; and
2. to mobilise and direct finance towards investment in climate mitigation, adaptation and resilience consistent with the objectives of the Paris Agreement and the SDGs, including by working within existing constraints to more effectively deploy public finance to leverage private finance.

A roadmap of key actions

Objective #1: Net zero / Paris alignment

Meeting the Paris Agreement goals will require a realignment of all global financial flows: financial institutions must take immediate action to ensure their activity is consistent with a 1.5°C global average temperature pathway. There is already growing ambition and action from leading financial institutions and welcome net zero momentum from asset owners and asset managers. However, unlocking systemic change will require coordination between all finance sub-sectors, policy-makers and regulators, and companies in non-financial sectors with a view to further scaling these commitments, and ensuring mutually reinforcing ambition and purpose.

In April, the UK COP26 Presidency and UN Race to Zero Campaign launched the *Glasgow Financial Alliance for Net Zero* (GFANZ) to unite firms from the leading net zero initiatives across the financial system to accelerate the transition to net zero emissions. GFANZ will provide a forum for strategic

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[4] https://www.un.org/pga/71/wp-content/uploads/sites/40/2017/02/New-Climate-Economy-Report-2016-Executive-Summary.pdf

[5] Aligning financial flows with the Paris goals may imply differentiated decarbonisation pathways in different country contexts. Paris alignment must therefore be accompanied by the development of clearer mitigation pathways that account for these differences.

coordination among the leadership of institutions from across the financial sector to accelerate the transition to a net zero economy, including by working to complement net zero commitments with efforts to mobilise trillions of dollars of finance towards the transition. Its members – representing around $70 trillion of assets under management – currently include asset owners, asset managers and banks. GFANZ is being rapidly expanded to draw in further sub-sector alliances, including insurers and reinsurers via the UN-convened Net-Zero Insurance Alliance (NZIA).

These efforts will help align private finance with the Paris goals, and provide financial institutions with a set of tools to smooth the transition. But to realise our goal of making all global financial flows consistent with a pathway towards zero greenhouse gas emission and climate-resilient investment, every financial institution must take immediate action to reorient their activity to these ends.

Proposals for 2021: Net zero / Paris Alignment

1. **Financial institutions make high ambition, credible, and transparent commitments to financing the transition to net zero.**
2. **Financial institutions develop agreed principles for net zero transition plans, including via aligning finance with sectoral transition and scaling investments in EMDEs.**
3. **Governments and regulators assess the mechanisms to encourage and support firms to publish net zero transition plans.**

Objective #2: Mobilising and directing finance towards climate action

Public finance, whilst critical, will not alone be sufficient to deliver on the objectives of the Paris Agreement and SDGs in developing countries. In recognition of the central role private finance must play to support EMDEs' transitions to low carbon, climate resilient development pathways, large parts of the private financial sector are looking for opportunities to complement their commitments to aligning financial activity with the Paris goals with significant deployments of private capital towards the transition in EMDEs. GFANZ will support efforts to mobilise finance to catalytic initiatives in low-income countries and emerging market economies. It will drive collaboration between financial firms to help identify and leverage leading methods for mobilisation, engaging with other initiatives as appropriate (e.g. Climate Finance Leadership Initiative (CFLI) and Global Investors for Sustainable Development (GISD)[6].

The private sector will need the support of a range of enabling partners including public financial institutions, among which multilateral development banks (MDBs) play a central role. MDBs can match the supply of finance to the demand in EMDEs, given their global and local expertise, hands-on experience in financing, and track record of working with both the public and private sectors. The MDBs are a major contributor to the $100bn goal of climate finance from developed to developing countries, including through direct mobilisation of private climate finance. They have taken significant steps to scale up private capital mobilisation as part of the 2015 "Billions to

[6] Voluntary carbon markets are one additional way of channelling investment to EMDEs. The Taskforce for Scaling Voluntary Carbon Markets (TSVCM) is working to scale an effective and efficient voluntary carbon market to help meet the goals of the Paris Agreement.

Trillions" agenda. The OECD estimates that private finance mobilised by multilateral climate finance[7] into developing countries (and attributed back to developed countries) reached $10.8bn in 2018, more than doubling compared to the 2016 level of $5.1bn. However, mobilisation of private climate finance from multilateral sources (i.e. including MDBs) remains relatively small – 14% – as a proportion of total climate finance provided from developed to developing countries ($78.9bn in 2018), and there is potential and significant need to do more.

Proposals for 2021 – Mobilising and directing finance towards climate action

4. **Financial institutions support mobilisation of capital to EMDEs, report on the percentage of their portfolio invested in EMDEs, report climate risk aligned with TCFD recommendations, and sign up to the Operating Principles for Impact Management.**
5. **MDBs produce and publish institution-specific private climate finance mobilisation action plans by COP26, that:**
   - *a.* **showcase their current and pipeline mobilisation offer and how they are working with private investors; and**
   - *b.* **outline how they plan to increase ambition on the mobilisation agenda over the medium-term and respond to demand from the private sector.**
6. **Based on the above action plans, MDBs set out how much private climate finance they collectively expect to mobilise per annum by 2025.**

MDBs have made significant progress in mobilising private climate finance. While individual MDBs have different mandates and areas of expertise, there are emerging areas of best practice and innovation that can be scaled and replicated across the wider MDB system. Building on existing efforts, we set out below potential areas where MDBs could seek to raise ambition in mobilising private climate finance, and which could be included as part of the MDB private climate finance actions plans (proposal 5, above). This would drive a more systematic approach to scaling mobilisation and better link the substantial supply of private climate finance with increased volume of bankable projects in EMDEs.

1) Supporting enabling environments and building markets

   a) *Improving the enabling environment to attract more private climate finance:* To unlock private finance, countries need support to improve policy environments, including reforms to reduce risk, policy uncertainty, institutional capacity, and the overall cost of doing business. MDBs already play a critical role here and can build on this and share best practice. Examples include developing rigorous PPP guidelines and regulations, which better facilitate transactions across multiple sectors. Country Mobilisation Platforms (discussed below) have great potential for coordinating MDB and private sector engagement on these reforms.

   b) *Supporting the issuance of green bonds*: A number MDBs have already proven this approach works. MDBs can support the scaling up of sovereign and local corporate green bond

[7] Multilateral public finance includes public finance provided from MDBs and Multilateral Climate Funds.

issuance, including assistance on appropriate regulation, pipeline development and outcome tracking. To attract investors who are interested in larger deal size and more diversification, MDBs could consider the development of investment vehicles that pool investments across a number of green bonds.

2) Directly mobilising private investment:

a) *Establishing investment vehicles and asset recycling:* MDBs already use a range of financial instruments to mobilise institutional investment into developing countries, for example, the IFC's MCPP model. We encourage MDBs to expand these facilities, ensuring they have strong climate objectives. Synthetic securitisation and exiting from existing commercially viable assets on MDB balance sheets by selling to the private sector could also expand opportunities for private investors, including by potentially accelerating the development of infrastructure asset sub-classes which better match the risk/return profile of institutional investors.

b) *Anchoring sector platforms*: MDBs have strong sectoral expertise in developing countries which they can deploy to further strengthen the pipeline of bankable projects. Sector-specific private 'platform developers', which have the substantive capital and sector expertise required to take on early stage risk in infrastructure projects, could support a greater volume of projects reaching financial close. There are some existing models to learn from – for example CDC's investments in Globaleq, GridWorks and Ayana. MDBs could seek opportunities to expand this model by investing in new commercially focused low-carbon sector platforms or leveraging the resources of existing platform developers, including into new sectors and geographies.

c) *Issuing green MDB bonds:* MDBs issue bonds to raise the financing they use for sovereign lending and private sector investment in developing countries. Many MDBs now issue green bonds to this end. The European Investment Bank (EIB), for example, issued the very first green bond in 2007. MDBs could consider whether such issuances could be expanded within their portfolio of bond issuances. In the longer term, any agreements by shareholders to provide additional capital to the MDBs could also support increased mobilisation through green bond issuances, especially if these were 'green capital increases'.

3) Shaping the architecture

a) *Country platforms:* We welcome the initiative under Workstream 2 to pilot 'Country Mobilisation Platforms', and look forward to the development of further such platforms. These can facilitate more coherent and complementary operations between governments, MDBs, DFIs, the private sector – including the local private sector – and other partners in-country to better address barriers to investment and explore development of commercial opportunities, including with key investor groups. Country Mobilisation Platforms should also be linked to other government-led platforms such as Integrated National Financing Frameworks.

SUMMARY OF PROPOSALS, CHANNELS AND PROPOSED TIMELINE

PROPOSAL	CHANNELS	TIMELINE
Objective 1: Net zero / Paris alignment		
1. Financial institutions make high ambition, credible, and transparent commitments to financing the transition to net zero.	Glasgow Financial Alliance for Net Zero	Commitments by COP26
2. Financial institutions develop agreed principles for net zero transition plans, including via aligning finance with sectoral transition and scaling investments in EMDEs.	Glasgow Financial Alliance for Net Zero	Principles developed by COP26
3. Governments and regulators assess mechanisms to encourage and support firms to publish net zero transition plans.	G20 Sustainable Finance Working Group	Report by October G20 FMCBG, as part of G20 SFWG Roadmap
Objective 2: Mobilising and directing finance towards climate action		
4. Financial institutions support mobilisation of capital to EMDEs, report on the percentage of their portfolio invested in EMDEs, report climate risk aligned with TCFD recommendations, and sign up to the Operating Principles for Impact Management.	Glasgow Financial Alliance for Net Zero	Commitments by COP26
5. MDBs produce and publish institution-specific private climate finance mobilisation action plans by COP26, that: a. showcase their current and pipeline mobilisation offer and how they are working with private investors; and b. outline how they plan to increase ambition on the mobilisation agenda over the medium-term and respond to demand from the private sector.	MDB boards G20 COP26	Announcement of commitment to develop action plans at Venice Climate Conference MDBs to report on progress at Annual Meetings in October MDBs publish private capital mobilisation action plans at COP26
6. Based on the above action plans, MDBs set out how much private climate finance they collectively expect to mobilise per annum by 2025.	G20 COP26	Announcement at Venice Climate Conference MDBs announce PCM for climate action targets at COP26