

PAULSON INSTITUTE - SIFMA - GREEN FINANCE COMMITTEE - UNEP INQUIRY
“GREEN FINANCE – A GROWING IMPERATIVE”

A Briefing

KEY
MESSAGES

- Transforming the financial system is key to promoting the green transformation of our economies, alongside environmental regulations, pricing reforms, and fiscal policies.
- Needed urgently is the scaled “industrialization” of green finance, which in turn requires international harmonization of definitions, products and standards.
- Market-based innovations are supporting the development of green finance, including green bonds and associated principles, definitions and standards, and enhanced risk analysis and disclosure.
- Public-private collaboration is needed to support the smart design and effective scaling of market innovations and policy measures to advance green finance.
- G20 has an important, continued role to play in policy signalling, converging definitions and standards, and exemplifying good practice.

Greening the Financial System

The financial system should play an important role in promoting the green transformation of our economies. The launch of the Sustainable Development Goals and the agreement reached at the Paris Climate Summit, both in 2015, established ambitious targets for transitioning the global economy along a low-carbon, inclusive and sustainable pathway. The key challenge remains how to fund efforts to reach these goals. Significant investments are needed, estimated at US\$5-7 trillion annually. China alone estimates green financing needs to be US\$600 billion annually. Public funds alone will not be adequate – China estimates that 85% of green finance will need to come from private sources.

China has launched an ambitious domestic program to develop a green financial system and is placing green finance as one of the priorities of its G20 Presidency. Many countries and financial institutions around the world are also advancing policies and practices that can unlock the global capital markets for a sustainable future.

“ The world is facing serious environmental challenges. We need to make stronger commitments to addressing them. We have tried many ways, including environmental regulations, pricing reforms, and fiscal policies. These have all worked in some way in controlling pollution and slowing the pace of global warming, but they are not enough. The financial system should also play an important role in promoting the green transformation of our economies.”

GOVERNOR ZHOU XIAOCHUAN, PEOPLE'S BANK OF CHINA

The Paulson Institute, together with the China's Green Finance Committee, the Securities Industry and Financial Markets Association (SIFMA), the United Nations Environment Programme (UNEP) and Bloomberg Philanthropies, co-hosted an event on 16 April 2016 at the Bank of America in Washington, D.C. to explore the implications of these developments for financial market actors and policymakers.

“ There is an opportunity for the G20 to create practical green financing models for the developed and the developing world. The good news is there is an abundance of capital globally, but governments need to create the proper conditions to attract this capital. They have an important role to play in setting the policies, regulations, incentives, and in ensuring that they are enforced.”

HENRY M. PAULSON, JR., CHAIRMAN, PAULSON INSTITUTE

Market Innovations Still Cottage Industry

Market-based innovations are driving the development of green finance. Green bonds are a case in point, with total issuance over the last three years exceeding US\$100 billion. Similarly, impact investing and other product innovations have been market-driven, from specialist funds, high-net wealth individuals and family trusts, and increasingly from institutional investors. It is largely broader public concerns rather than policy measures that have driven demands for negative screening to reduce the presence of environmentally intensive and high-risk assets in investment and lending portfolios.

Today, however, green finance remains a 'cottage industry'. Green bond issuance and green infrastructure investment are under one per cent of total bond issuance and total infrastructure investment respectively. The core challenge is to move beyond green finance as a cottage industry – effectively to “industrialize” it to realize the needed scale.

Moving to scale requires key barriers to be overcome. Early stage markets are suffering from ambiguity, high costs, reputational risks and low liquidity. Overcoming such barriers to realize scale in turn needs:

- * Clearer standards that harmonize products and lower costs across international markets.
- * Improved environmental risk analysis, including use of scenarios.
- * Enhanced disclosure of information relevant to investors, issuers and lenders to incent the market to develop green projects.
- * Smart use of concessionary public finance to lower the cost of capital for green projects, such as by: introducing an implicit government guarantee model; utilizing multilateral development banks' AAA balance sheets to raise capital for green projects; introducing “blended finance”; and offering tax-exempt status for green investments.
- * Extended pipelines of investable projects to apply green finance.

Role of Government

Governments, individually but also collectively through the G20 and other platforms, can contribute to overcoming current barriers. Robust and predictable policy environments are of critical importance, including everything from adequate enforcement of environmental regulations, to green-smart public procurement and through to country and international action to establish effective carbon pricing regimes. Similarly for policy action in greening financial markets, including:

- * Broad policy signalling, such as through the Paris Climate Agreement, the universal adoption of the Sustainable Development Goals, and their incorporation into national plans and international processes such as the G20's investment and growth framework.
- * Specific support in scaling green finance, such as through the development of standards and common metrics, by encouraging development finance institutions to harmonize their definition of what constitutes green finance as well as their approaches to credit enhancement and risk mitigation by ensuring market integrity in the scaling of green finance by requiring effective disclosure and oversight.
- * Encourage multilateral institutions to develop a common set of criteria for what constitutes green finance from a risk mitigation and return perspective, rather than having them focus on their own regional needs and circumstances, to help scale up the green financing opportunity and create a global asset class for green finance.
- * Setting specific investment standards to help grow the market and create investor certainty and mobilize investment capital (for instance, specific “negative screens” set forth in California’s investment guidelines established a specific threshold by which investments cannot be defined as green projects, which help institutional investors to mobilize investment capital).
- * Demonstrating how climate shocks will affect the financial system.
- * Develop government incentive programs that set clear goals regarding the investment criteria and risk appetite for green projects, with appropriate governance structures to ensure fraud protection.
- * Introduce incentives to decrease the cost of capital for green projects, improve investor certainty, and mobilize investment capital into green investments.
- * Improve market-based pricing by reducing fuel subsidies, eliminating subsidies for oil and carbon-intensive projects, and introducing carbon pricing, which will induce finance to flow towards green investments.

Success in scaling depends on achieving the right balance of market and policy action. There is a need to avoid policies or regulations that would unnecessarily overlay, or even undermine, what the market can achieve alone. That said, market-based innovations can and often need to be complemented, accelerated, or in some cases made possible by policy measures.

- * Green bond issuance has risen rapidly as a result of healthy market demand and industry-developed guiding principles, with development banks playing a critical market-making role, and regulators in some instances shaping national standards, such as the People’s Bank of China’s green bonds guidelines.
- * Focus on efforts to standardize investment standards by ensuring that the “Principles for Responsible Investing” and “Green Bond Principles” fit together to avoid investor and issuer confusion, and promote capital markets financing of green products.
- * Improved disclosure of environmental risks has been driven by market practice, reinforced by changes in listing requirements across many of the world’s major stock exchanges,

often encouraged by public actors, such as the Financial Stability Board's Climate-Related Financial Risk Disclosure Task Force.

- * Increase the supply of green bonds and other green finance instruments by allowing secondary market trading, re-labelling bonds as "green" if they meet the necessary criteria, and developing the project pipeline of investible green projects.

Collaboration between government and the market can optimise the pathway to scale. Collaboration is needed to identify opportunities and barriers, build on market innovations and design enabling policy interventions, design change pathways, and ensure robust yet flexible implementation through transparency, rapid impact feedback and ongoing dialogue.

- * China's green finance plan emerged from the work of the Green Finance Task Force, co-convened by the People's Bank of China and UNEP, involved over 40 Chinese market and non-market actors, and benefited from access to international expertise.
- * To improve transparency in the green finance market, utilize green indices, standardize in legal/regulatory policy "negative screens," and work with credit rating agencies to reflect the sustainability of green projects' cash flows in credit ratings (i.e. to show the pricing differential between green and non-green projects), all of which would help guide investor behavior.

G20 Role

Green finance has been prioritised under China's G20 Presidency, notably through the Green Finance Study Group and the Financial Stability Board's Climate-Related Financial Risk Disclosure Task Force. Much progress is being made in 2016, notably in mapping and analysing existing practice, and in setting out options for voluntary action by financial institutions, and through national roadmaps and international cooperation. Beyond these initial steps, much can be done through the G20 and related platforms, in harmonizing standards in the green bond market, developing green bond ratings criteria, building method and capacities, improving information flows and aligning incentives, thereby enhancing the consideration of environmental matters in financial market decision-making.

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