

SUSTAINABLE FINANCE POLICIES FOR 1.5°C

Policymakers must grasp the opportunities inherent in the transition to net zero

A rapid green transition will result in trillions of savings according to the latest modelling.

Transition will be economically beneficial without even accounting for the avoided costs of climate damages or other climate policy co-benefits.¹

The transition can enable energy sovereignty, economic diversification, and job creation. Appetite for sustainable investment is very high. By aligning development plans and investments with green, global policymakers can harness the momentum and leverage private capital flows to fund infrastructure and development.

Without rapid climate action, countries will experience a rising cost of capital and stunted growth

Limiting warming to 1.5°C is necessary to avoid catastrophic human, ecosystem, and financial impacts. Human-induced climate change is already resulting in severe physical hazards.² Both physical and transition risks will result in major financial risks.³ While the costs of tackling climate change are high, the costs of inaction are higher.⁴

Physical climate risk exposure has already increased the cost of capital in vulnerable countries, costing the V20 USD62bn in higher external interest payments over 10 years.⁵ The 20 sovereigns with the highest ratio of net fossil fuel exports to GDP suffered a median net downgrade of 1.6 notches 2015-2020 and two defaulted according to Fitch Ratings.⁶ Delayed action on transition will not only endanger the 1.5°C goal, but abrupt policy changes will also result in higher transition risks and increase cost of transition.⁷

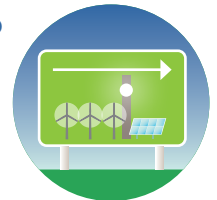


Global capital must be directed to where the need is greatest

Redistribution of capital requires changes in risk appetite and understanding. Recognition of the risks of high-carbon investment will enable its rapid decline and redeployment to sustainable investments. New fossil fuel investments must cease immediately, and many existing plants undergo early retirement if we are to meet 1.5°C.⁸ The current energy crisis may require use of fossil fuels to meet short-term shortfalls, however medium- and long-term energy security will be met by increased renewable energy and energy efficiency.

Global capital flows are large, but risk appetite is low. Development finance institutions (DFIs) and government investment can facilitate the flow of capital to riskier projects by absorbing the higher-risk (junior capital) portion and offering the lower-risk (senior capital) portion to private investors in blended finance deals. This mobilises private finance to support higher risk projects, whether nascent technologies or in emerging markets (EM).

Limiting global warming to 1.5°C is achievable, understanding our capabilities to transition will increase policymakers' ambitions. Despite the narrowing window to meet 1.5°C, maintaining this ambition is crucial to limiting climate change as much as possible.

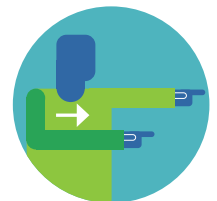


Policymakers can direct capital to meet sustainable development needs and deliver the most urgent mitigation and adaptation projects

Coordinated sustainable finance policy frameworks should be embedded in the wider development context. The starting point for these policies is robust national and sectoral emissions budgets, aligned with the 1.5°C global carbon budget. Decarbonisation can then be embedded within national development strategies.

Collaborative action is key, to provide investment clarity and prevent inefficiencies. Global policymakers, including governments, central banks, regulators and DFIs can initiate policies to direct the flow of finance towards climate action.

The sustainable finance policy framework to access and direct capital flows to deliver sustainable development and the net-zero transition can be divided into three core pillars:



1. Provide clarity on what is a green and resilient investment



A **Green Taxonomy** is a crucial mechanism to give all actors guidance on what is green. Including **transition** in the taxonomy provides guidance on how to decarbonise high-carbon activities, and enables financing of these activities' transitions. Aligning with international taxonomies and standards will enable international private finance flows.⁹ Adapting an international taxonomy to the national context also requires less capacity than developing a taxonomy from scratch.

2. Tilt investment to green opportunities



Many policies will tilt investment flows away from high-risk carbon-intensive and towards green investments. These can insulate economies from climate-related risks and open up green development opportunities.

Scale junior capital to increase investment flows

- Government **guarantees** de-risk green bond issuance, allowing institutional investor participation. This encourages green bond issuance over vanilla. **Sovereign-to-sovereign** guarantees will work in the same way and decrease cost of capital for EM sovereigns.
- DFI **guarantees and credit enhancement** can channel investment to EM and higher-risk projects by clearing a path for investors to reach senior tranches of debt. Isolating and funding junior tranches can overcome the challenge of matching conservative risk appetite with available investment opportunities. As much of the capital available for transition is highly risk averse, guarantees are crucial to meet senior debt appetite and overcome the challenges posed by lack of junior capital.
- Increase **blended finance** provision. This leverages concessional financing to reduce a project's credit risk, allowing for greater mobilisation of private capital. The Development Bank of South Africa's Climate Finance Facility enables long-term renewables financing.¹⁰ Including other **de-risking facilities** such as policy risk hedging can provide protection from negative market fluctuations and can further increase financing flows, especially important in EM where access to long-term capital is limited.

Mitigating risk to ensure rapid green capital flows

- Require investors and corporates to publish **transition plans**, as required in UK sustainability disclosures.¹¹ This step can prompt immediate action. The government can then introduce risk tools for **long-term assessment of transition plans** and their impact on exposure. Basing these on robust standards such as the Climate Bonds transition and entity criteria will ensure credibility and speed of transition.¹²
- Encourage the use of green financial instruments through **subsidies and incentives** which reduce cost of green capital and ensure attractive returns. E.g., Singapore's Sustainable Bond Grant Scheme covers additional costs of labelled issuance.¹³
- **Targeted subsidies** are crucial to enable cost competitiveness of specific green technologies and to enable industrial transitions, for example, the US subsidies for low-carbon hydrogen production.¹⁴
- **Remove perverse subsidies** (on fossil fuels, damaging ecosystem practices etc.) which distort perceptions of climate-related risk. This also immediately frees up a significant level of government spending, which can be reoriented to fund transition investments.

- Central banks (CB) **recognise climate risk as a risk to financial stability** and address it across prudential and monetary policy. Many policies can be, and have been, adapted to incorporate climate risk considerations without waiting for disclosure and stress testing evidence.
- The CB can adjust **risk weightings** for capital and reserve requirements and collateral frameworks to incorporate climate risks.¹⁵ This will help insulate the CB balance sheet from climate-related risk and encourage FIs to green their capital allocation. Hungary's CB established preferential capital requirements for green mortgages, based on their lower default risk.¹⁶

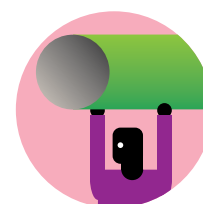
Strengthen carbon pricing to drive change

- Carbon prices need to be high and stable to ensure investor confidence in the price signal. **Carbon pricing reform** is needed, removing free allowances, and limiting purchase of carbon credits, so that pricing can force change.
- Carbon credit trade threatens the transition if purchased to offset avoidable emissions. Market reform can identify qualified offset purchasers. This can ensure credits are **reserved for residual emissions** and focus on preserving high carbon stocks.
- **Carbon border adjustment mechanisms** (CBAMs), whereby imports are also subject to local carbon pricing, are important to avoid relocation of high-carbon activities to countries without pricing schemes.¹⁷
- **Overreliance** on carbon pricing could hinder transition if it delays implementation of other mitigation policies.¹⁸ Particularly in EM, **non-price instruments** may better overcome political economy restraints and avoid regressive impacts on consumers.¹⁹

Capture the opportunities of transition

- Establish **green trade windows**, with low tariffs for low-carbon trade. This can compensate for CBAM limitations and facilitate the flow of capital to EM, crucial to the success of the global transition.
- Establish **energy transition mechanisms** to fund early retirement of fossil fuel assets, and their replacement with renewables installations. ADB's pilot mechanism uses blended financing to buy and retire or repurpose coal plants in Indonesia, Philippines and Viet Nam.²⁰ Energy transition mechanisms can address the financial risks of continued fossil fuel asset operation and create social just transition opportunities.

3. Build green investment pipelines to deliver resilient economic development



This pillar requires forward-looking policies that will **shape the future investment landscape**. This requires investment in **research and development**, and long-term incorporation of climate considerations into planning. This will result in innovative financial and technical solutions, green urban development, and growth of conservation areas.

101 policy ideas for a sustainable finance policy package

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SUSTAINABLE FINANCE POLICIES FOR 1.5°C

Department/ policymaker	Provide clarity on green	Tilt investment to green opportunities			Build green investment pipelines
		Private finance	Public finance	Blended finance	
Government leadership	<ul style="list-style-type: none"> 1. Common understanding of climate change 2. Set direction 3. Policy coordination 	<ul style="list-style-type: none"> 4. Encourage private action 			
Finance	<ul style="list-style-type: none"> 5. Coordinate whole government action 6. Sustainable finance roadmap 7. Taxonomy and standards 8. Central bank mandate/remit 	<ul style="list-style-type: none"> 9. Green finance subsidies 10. Tax incentives 11. Regulatory KPIs 12. Environmental tax reform 	<ul style="list-style-type: none"> 13. Green sovereign wealth fund 14. GSS sovereign issuance 15. Resilience spending 16. Debt for nature swaps 17. Green public investment/financial management 18. Green budgeting 19. Sovereign to sovereign guarantees 	<ul style="list-style-type: none"> 20. Green guarantees 	<ul style="list-style-type: none"> 21. Identifying green investment pipeline
		<ul style="list-style-type: none"> 22. Fossil fuel subsidy phaseout 23. Carbon pricing 			
Development Finance Institutions	<ul style="list-style-type: none"> 24. TCFD disclosures 25. Data provision 	<ul style="list-style-type: none"> 26. Anchor investment 27. Capacity building & technical assistance 	<ul style="list-style-type: none"> 28. GSS bond issuance 29. Increase green & resilience spending 30. Change risk appetite 31. Climate-conditional debt relief 32. Public sector deal structuring 	<ul style="list-style-type: none"> 33. Guarantees & credit enhancement 34. Loan syndication 35. Provide blended finance & grants 36. De-risking facilities 	<ul style="list-style-type: none"> 37. Project pipeline development 38. Green aggregation facilities
Central bank		<ul style="list-style-type: none"> 39. Stress testing 40. Disclosure requirements 41. ESG risk management standards 42. Capital & reserve requirements 	<ul style="list-style-type: none"> 43. Tilt credit operations 44. Green foreign exchange reserves 45. Adjust Collateral frameworks 46. Green credit guidance 		<ul style="list-style-type: none"> 47. Green finance research and analysis
Supervisors and regulators	<ul style="list-style-type: none"> 48. Sustainable finance guidelines 	<ul style="list-style-type: none"> 49. Encourage action by individual financial institutions 50. Integration of client's sustainability preferences 51. Disclosure requirements 52. Assess transition plans 			<ul style="list-style-type: none"> 53. Regulatory sandboxes for financial innovation 54. Green securitization framework
Stock Exchange		<ul style="list-style-type: none"> 55. Listing requirements 56. Green bond segment 57. Fast track green bonds 			
Rating agencies		<ul style="list-style-type: none"> 58. Increase transparency on rating methodologies 59. Lengthen risk horizons 			
Trade		<ul style="list-style-type: none"> 60. Carbon border adjustment mechanism 	<ul style="list-style-type: none"> 61. Green export credit agencies 		<ul style="list-style-type: none"> 62. Green trade window

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Infrastructure			63. Embed resilience and mitigation in infrastructure plans 64. Integrate climate in national disaster plans and insurance 65. Prioritise strategic infrastructure	66. Green PPP framework 67. Hydrogen clusters	
Energy production	68. Energy standards	69. Ease RE permits and auctions 70. Feed in tariffs 71. Carbon contracts for difference 74. Fossil fuel phaseout	72. Energy transition mechanisms		73. Aggregation of distributed RE
Buildings		75. Buildings standards 76. Incentive schemes 77. Energy efficient mortgages	78. District heating networks		
Industry	79. Transition standards	80. Guarantees 81. Sectoral subsidies 82. Green PE and VC	83. Green public procurement		84. Targeted R&D support
Transport		85. Land value capture 86. EV incentives 87. Develop charging network 88. ICE phaseout	89. Green public procurement 90. Green municipal bonds		91. Urban planning 92. R&D support
Environmental protection		93. Enforce conservation laws 94. Transparency on nature-related risks and opportunities 98. Establish nature-based metrics for financial instruments	95. Recognise economic value of conservation 96. Payments for ecosystem services		97. Reform carbon credit market
Agriculture		99. Embed climate & biodiversity considerations in rural development 100. Green preferential tax policy 101. Subsidy reform			

These 101 policies will each be explored in the full report

Endnotes

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Lead Author: Lily Burge

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