Aligning Finance with low emission, climate resilient development pathways

Reflexions about a
Forthcoming report of Climate Strategy for the Green Climate Fund

Jean-Charles Hourcade
CIRED – CNRS

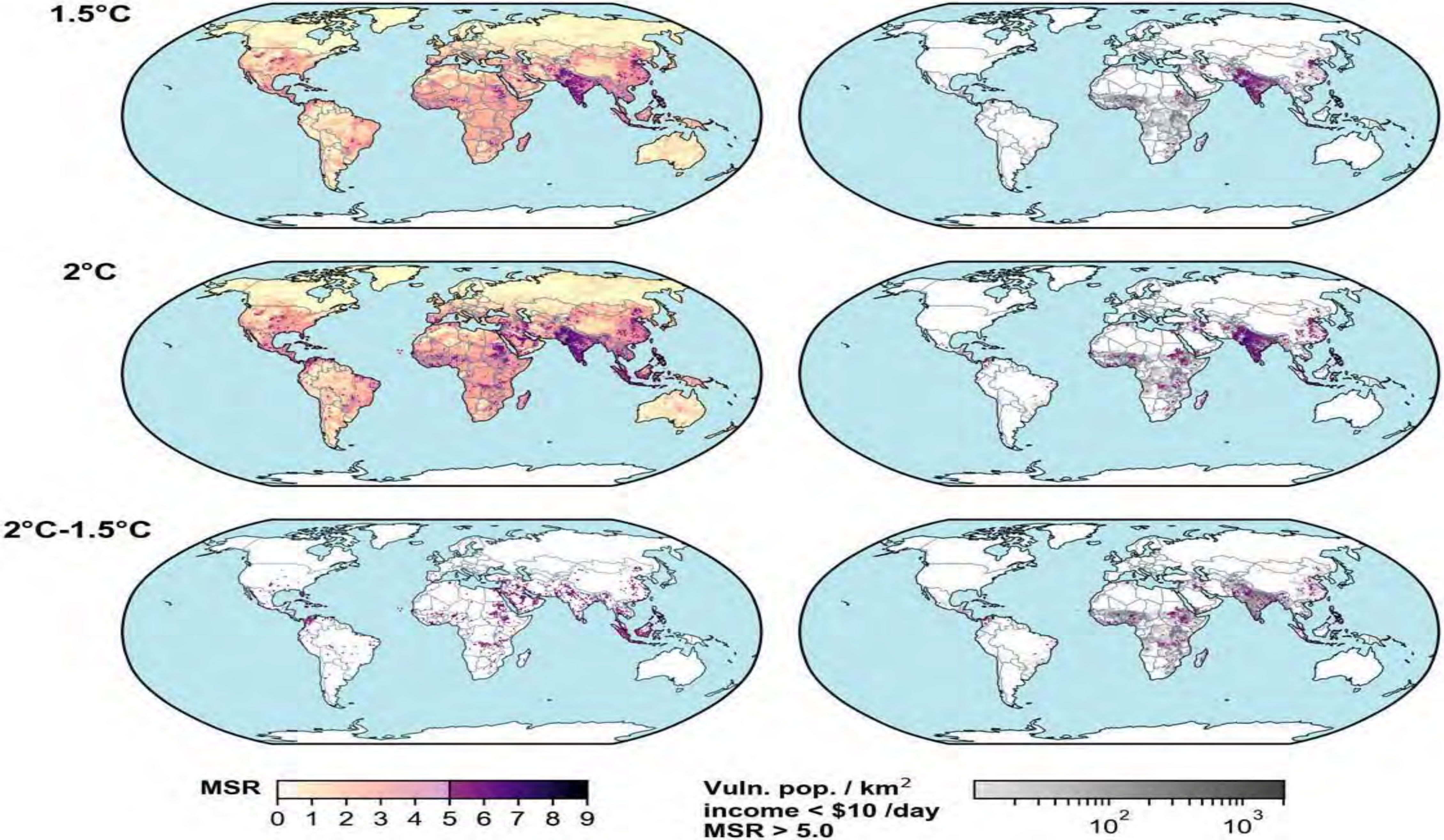
The Pathway Towards Decarbonisation—Message from Scientists Towards Green Recovery

LCS – Rnet webseminar: 13 November 2020, 16:30-18:00

A suprising disconnection between two strands of literature on climate finance: a new form of TD/BU controversy?

Marc Carney (2015) -> Central Banks + Institutional Investors -> financial system potentially destabilized by ***Physical risks*** and ***Transition Risks*** -> Task Force on Climate Finance Disclosure -> Network for Greening the Financial System -> EU Taxonomy

Development Banks -> de-risking LCI -> unlocking the ‘demand side’ barriers to climate finance (lack of projects proposal)



1.5°C
2°C
2°C-1.5°C
MSR
0 1 2 3 4 5 6 7 8 9
Vuln. pop. / km^2
income < $10 /day
MSR > 5.0
10^2
10^3

What risks of financial systemic shock are we talking about?

Type of institutions possibly impacted

Credit Providing Institutions mostly concerned by ‘transition risks’

Institutions holding Climate Impacted Assets mostly concerned by ‘physical risks’

- **Two behavioral hypothesis**
  - **Gradual revision of the statistics behind the calculation of the Value at Risk**
    - Disengagement of **Institutions holding Climate Impacted Assets**
    - Higher risk-coefficient for **Credit Providing Institutions**
  - **Revision of statistics swamped by the debt driven momentum of permanently revalued assets ->** already-stressed balance sheets + high levels of corporate and municipal debts + highly destructive events affecting key economic hubs + revision of expectations about technological options -> sudden spike in risk aversion -> ….. Financial crisis

Limits of the TCFD and Taxonomy approaches

- **Problems of definition and metrics**
  - Contradiction between the need for standardized and simple ‘marks’ and the difficulty of scientifically meaningful indicators for scope 1, scope 2 and scope 3
  - Problems for cement, glass, steel etc … that are needed in a low carbon world
  - Problems of avoiding a ‘carbon centric’ evaluation
- **Problems of efficiency for conducting the low carbon transition**
  - Reducing the carbon content of a financial portfolio can be made without investing in low carbon and climate resilient options (
  - The ‘blame and shame’ dynamics might be difficult to control and freeze corporate decisions

NO GREENING OF FINANCIAL PORTFOLIOS WITHOUT SCALING-UP OF GREEN PROJECTS

Scaling-up low carbon and climate resilient investments: the nature of the challenge prior and after the COVID

1. ***Redirect 2,5% of the world savings***
2. ***Narrow the investment infrastructure gap (***15,9% to 32% in 2040)
3. ***Multiply by 1,24 to 2,36 SDGs investment*** (water, sanitation, flood protection and irrigation)
4. ***Reduce uncertainty for businesses and savers by indicating where savings should go***
5. **Reduce the mismatch between the geography of savings, capital flows and infrastructure investment needs** (mind countries 'creditworthiness and access to capital)
6. ***Change the 'business environment' that leads risk-adverse financial players to direct more savings towards liquid financial products and real estate***
7. ***Provide an anchor to a contemporary financial system*** fragilized by the ***absence of mechanism that automatically returns capital markets to equilibrium***
8. **Overcome the chicken and egg problem that blocks the generation of projects**

Risks

A temporal profile often forgotten

lack of familiarity with technical options and geographies, fragmented financing windows,

limited project preparation expertise

country specific risks (exchange rate risk, demand risk, expropriation,)

Underperformance of technologies

Bidding and development	Construction period	Ramp-up period	Operation period

Up-front de-risking of LCIs and generation of new assets classes

- *Policy de-risking* (streamlining and *Financial de-risking* (transfer the investment risks to public institutions the lower risk-weighted capital costs and the 'switching' carbon prices
- *Need to increase the leverage of public funds or private funds (<2%* today)
- **Multilateral guarantees to secure the credibility of projects**
    - ***Third Party actors in new Public-Private partnerships***
    - Standardisation and transparency of the selection and MRV processes through agreed methods to assess the ***avoided tons of emissions*** by type of project and type of geography and ***value them*** at an agreed upon social value Article 108 of the decision of the PA)
    - Defragmenting development finance
    - Involving ***local banks*** to speed-up the local financial sector's involvement and the ***access to loans in local currencies to lower the debt stress of the host country***

- *Assets* incorporated in the balance sheets of actors and *recognized by central banks (circumvent the Basel III guidelines for liquidity* and the EU's Solvency II directive
- Climate Remediation Assets with a predetermined face value a tangible substitute to stranded assets and used by Central Banks in their interpayment operations -> a *carbon based reserve currency*

The Finance-Climate Nexus in the Post Covid context
Elements for our panel discussion

Decline in external balance of DCs: **-** 700 G$ in ODA eligible countries, -35% of foreign equity investments, 80G$ of outflow of equity in March
Downgrades in sovereign credit ratings: **t**he G20 freezes 5 G$ of debt payments for 42 LDCs
- But increase in spreads: 90 countries below BBB instead of 60 today: spreads > 18% for 2 years projects

Solvency risks and liquidity crisis: Affect primarily the SMEs: that have no financial buffer
But higher savings rates in middle/upper classes …. Risks of misallocation

Systematic quantitative easing -> overflow of national currencies but lack of international currency ->DTS reinforced role of the US $ as the dominant reserve currency?

The ‘Green Deal’ as a lever of economic recovery and financial stability:

- The infrastructure sectors have a dominant share in the world gross capital formation. They can have a strong knock-on effect, will generate a more domestic-oriented growth pattern and are critical for social inclusion

- NDCs supported by **multilateral sovereign guarantees** will say where the money should go and help recovering the sense of reciprocal gains of international cooperation

- Towards a financial system that **reduces the gap between what capital value et what people value** (marc Carney)