Sustainable Finance – Bridging the Gap in Asia and the Pacific

<u>Session 7 - How can innovative instruments expand the flow of sustainable finance through capital markets?</u>

Financing for Development Section

Macroeconomic Policy and Financing for Development
UN Economic and Social Commission for Asia and the Pacific (UNESCAP)

2 December 2022

UNITED NATIONS
ESCAP
Economic and Social Commission for Asia and the Pacific

Overview

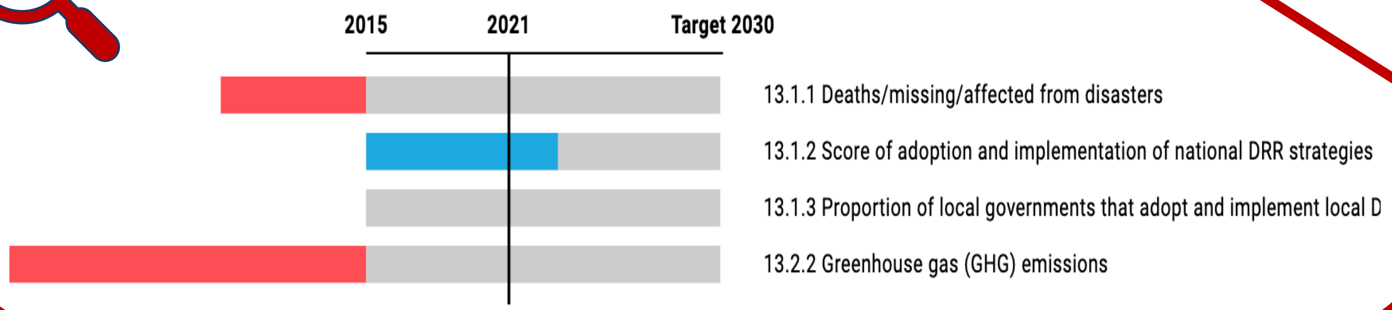
1. *Background: Sustainable Finance in the Asia-Pacific*
2. *How Can Innovative Instruments Expand the Flow of Sustainable Finance Through Capital Markets?*
3. *Key recommendations*
4. *Expert Discussion*

1. Background: Sustainable Finance in the Asia-Pacific

Asia and the Pacific is not on track to meet the SDGs

Good progress on No Poverty (Goal 1), Affordable and Clean Energy (Goal 7), and Industry, Innovation, and Infrastructure (Goal 9)

Progress on Goal 13 on Climate Action has regressed across all Sub-regions

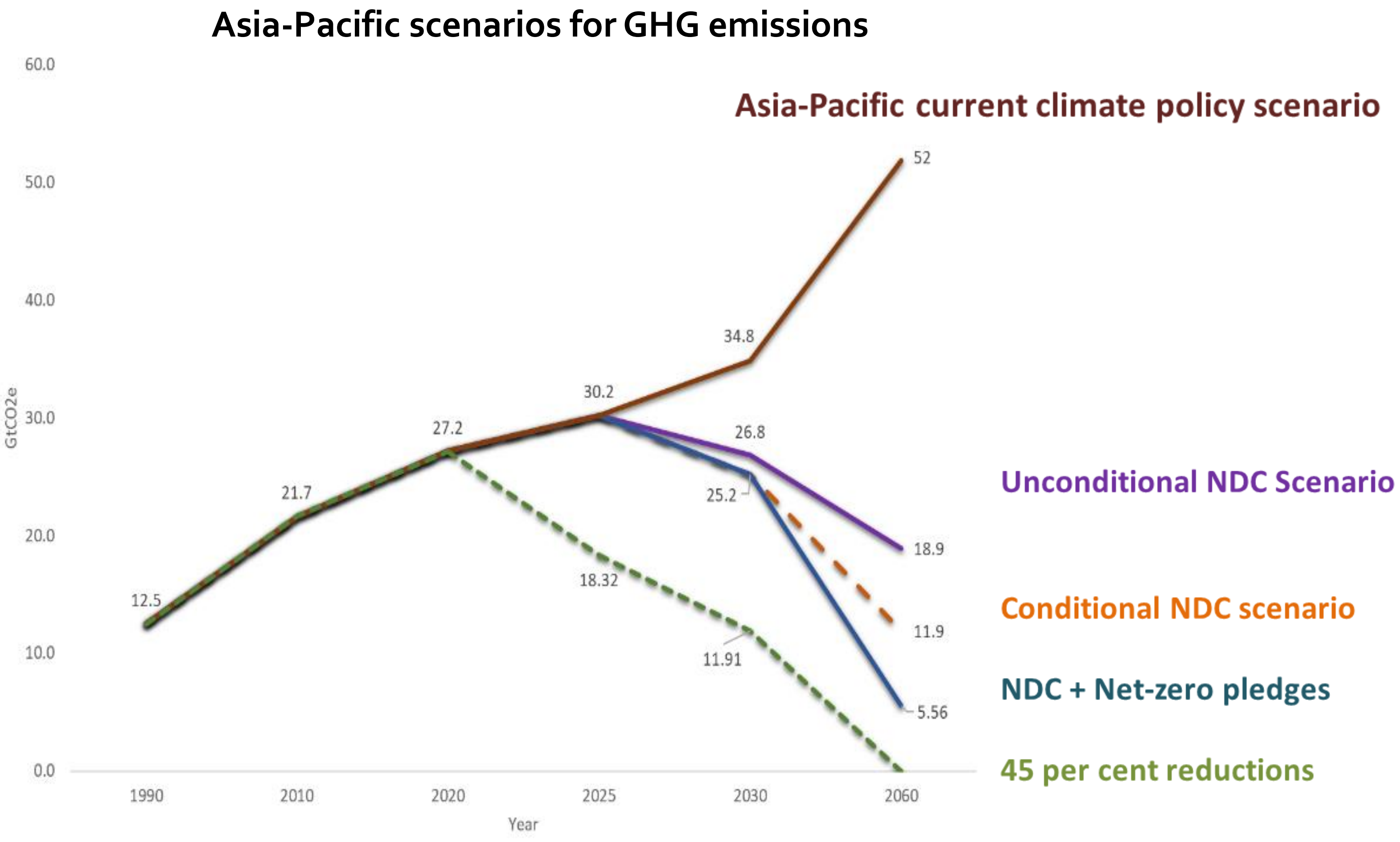


2021 SDG progress at indicator level in Asia and the Pacific

Source: ESCAP, SDG Progress, https://data.unescap.org/data-analysis/sdg-progress# (accessed 11 November 2022)

Asia and the Pacific accounts for more than 50% of global CO2 emissions, with more than half coming from electricity and heat

- Large populations in Asia and the Pacific live close to **locations prone to drought, floods, and rising sea levels**
- Asia's **demand for energy** is projected to double in 2030
- **GHG emissions** expected to be reduced in Asia-Pacific by **7.6% between 2020 and 2030,** which falls significantly short of the 45% reduction between 2010 and 2030 required by the 1.5°C pathway



Source: ESCAP, UNEP and UNICEF, 2022 Review of Climate Ambition in Asia and the Pacific: Raising NDC targets with enhanced nature-based solutions , https://www.unescap.org/kp/2022/2022-review-climate-ambition-asia-and-pacific-raising-ndc-targets-enhanced-nature-based.

Lack of consensus and sufficient data on total financial needs to meet countries' Nationally Determined Contributions (NDC)

Annual financial needs of all developing countries in Asia and the Pacific to meet **NDCs** estimated to be **$362 billion per year**

including $258 billion in mitigation and $104 billion in adaptation

This is still likely an under-estimate. Potential cost up to $532 billion per year by 2025 and $1.2 trillion by 2030

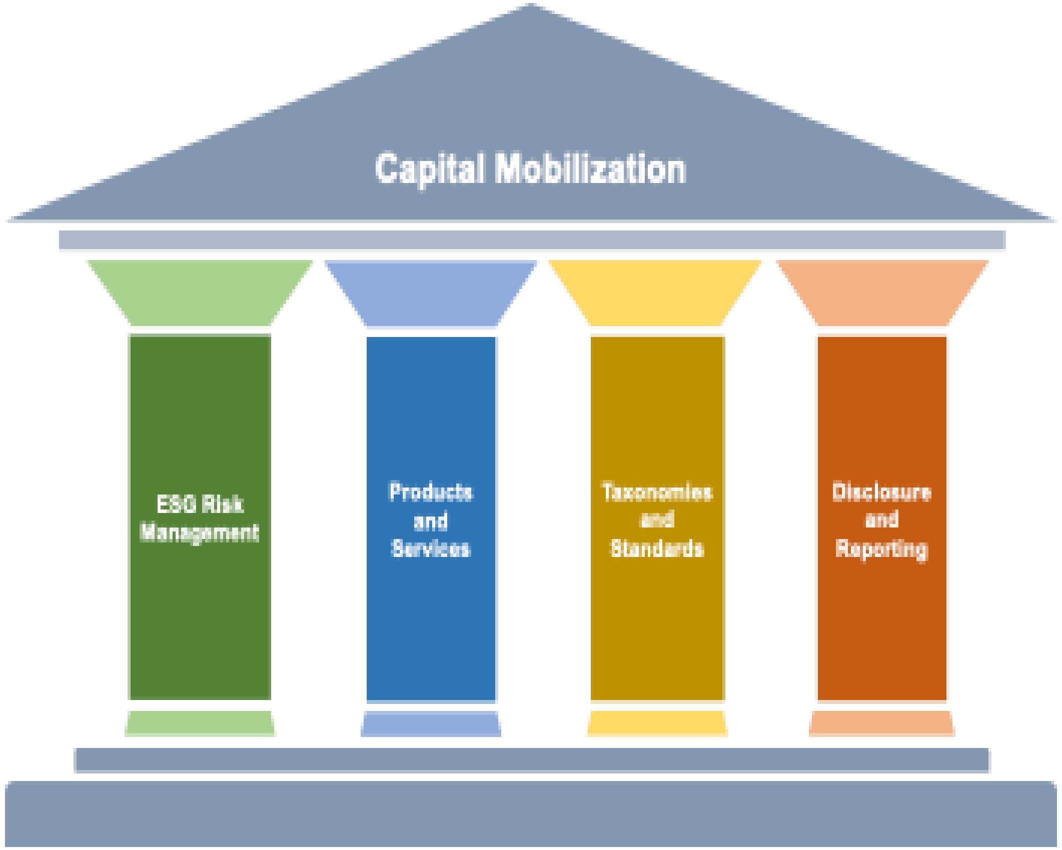
18 Asia-Pacific countries that are party to the UNFCC currently reported **estimates of financial needs** in their latest NDCs – covering only 1/3 of Asia's population

$1.31 trillion financial needs currently reported by Asia-Pacific countries for mitigation and adaptation, of which 80% coming from India alone

70% of currently reported financial needs is allocated to **mitigation** and **30% for adaptation**

*Enhancing **access to climate finance** key to incentivize rapid decarbonization by 2030*

Foundational Elements of Sustainable Finance

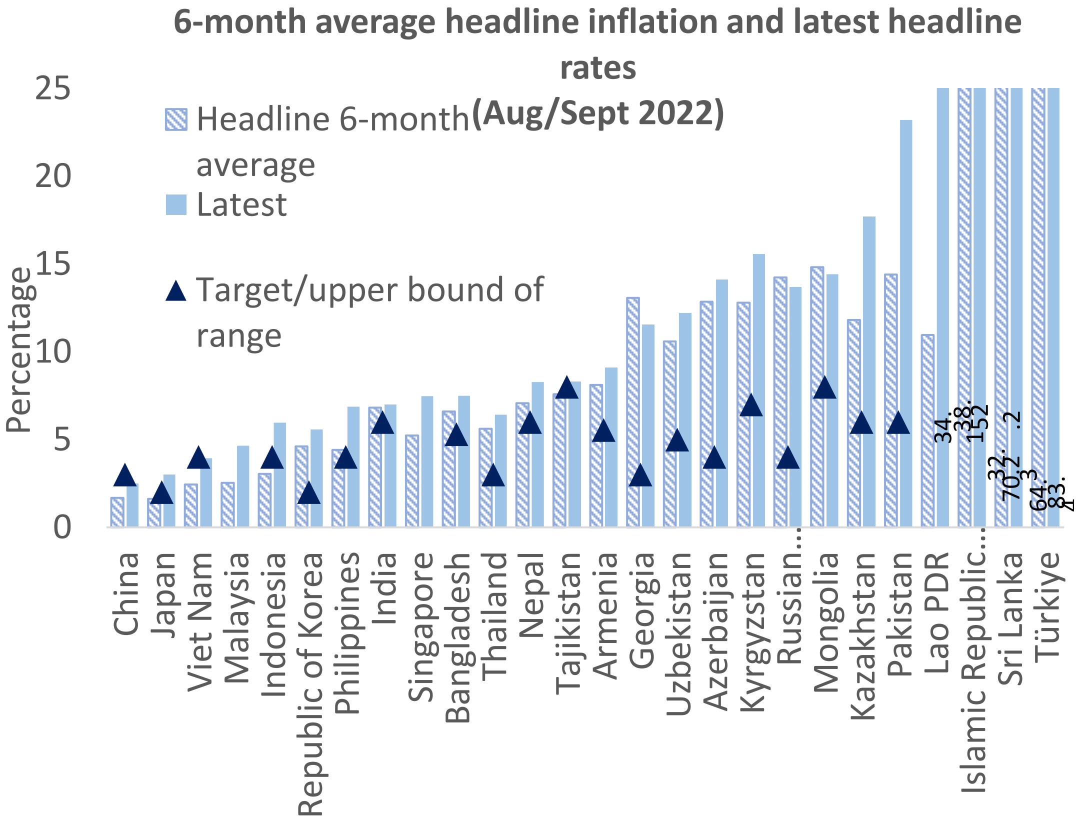


Source: ESCAP

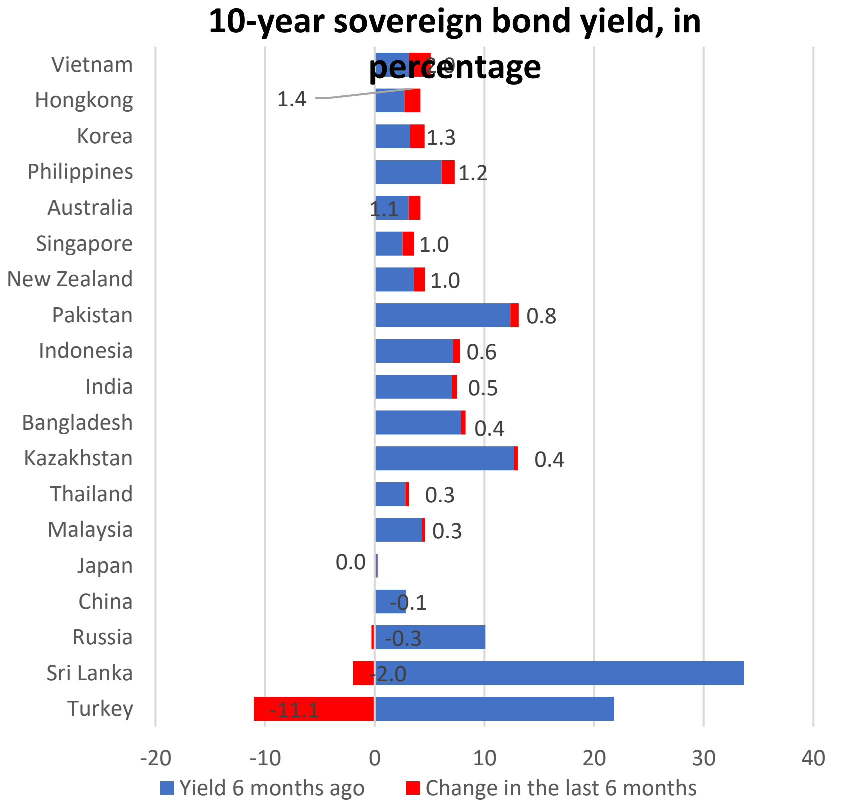
*Essential to not only mobilise capital for sustainable projects but to **ensure that factors such as climate and the environment are fully integrated into mainstream financial systems,** processes and policy, across all sectors and asset classes and within broader financial and banking system*

Challenging macroeconomic environment due to rising inflation and interest rates..

Inflation pressure has reached double digits in several Asia-Pacific economies, surpassing central bank targets



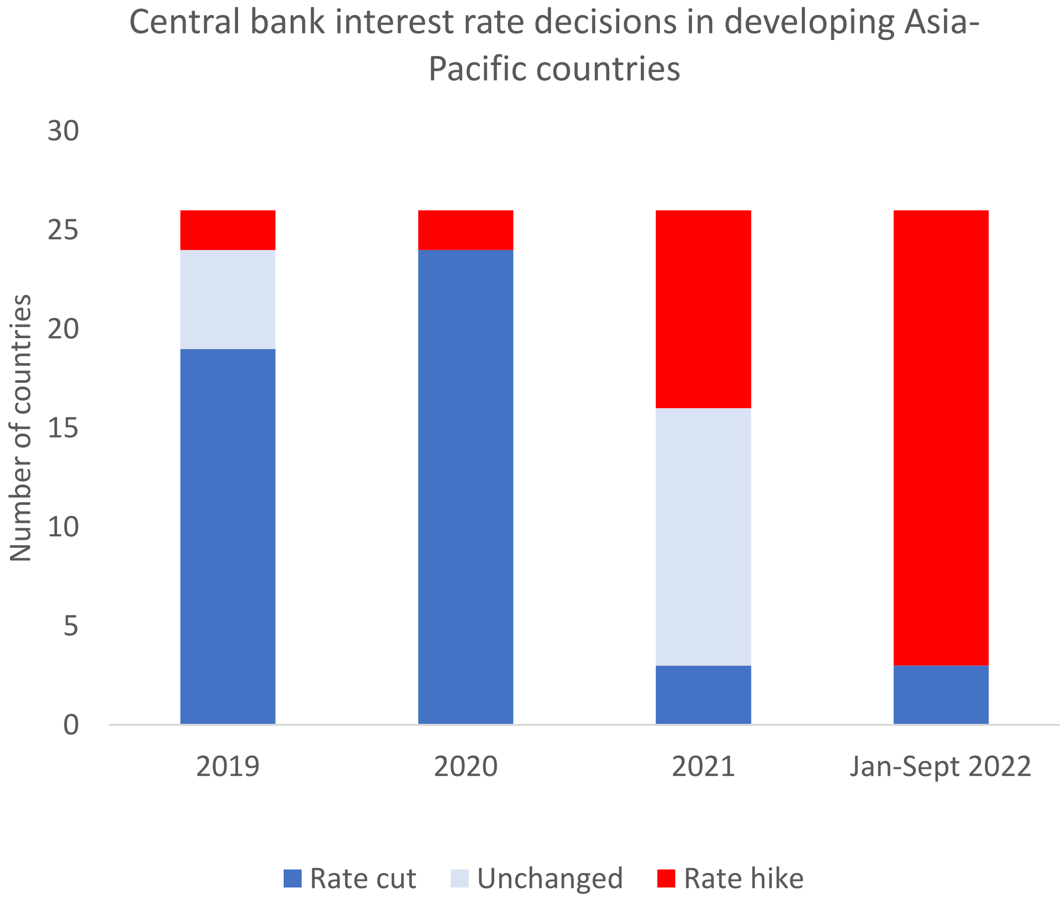
Further compounded by depreciating exchange rates and capital outflows to safe havens… resulting in higher risk premiums and rising borrowing costs



Source: ESCAP

How will rising interest rates impact sustainable finance

Monetary tightening in advanced economies and domestic inflationary pressures are leading to rising interest rates in Asia-Pacific

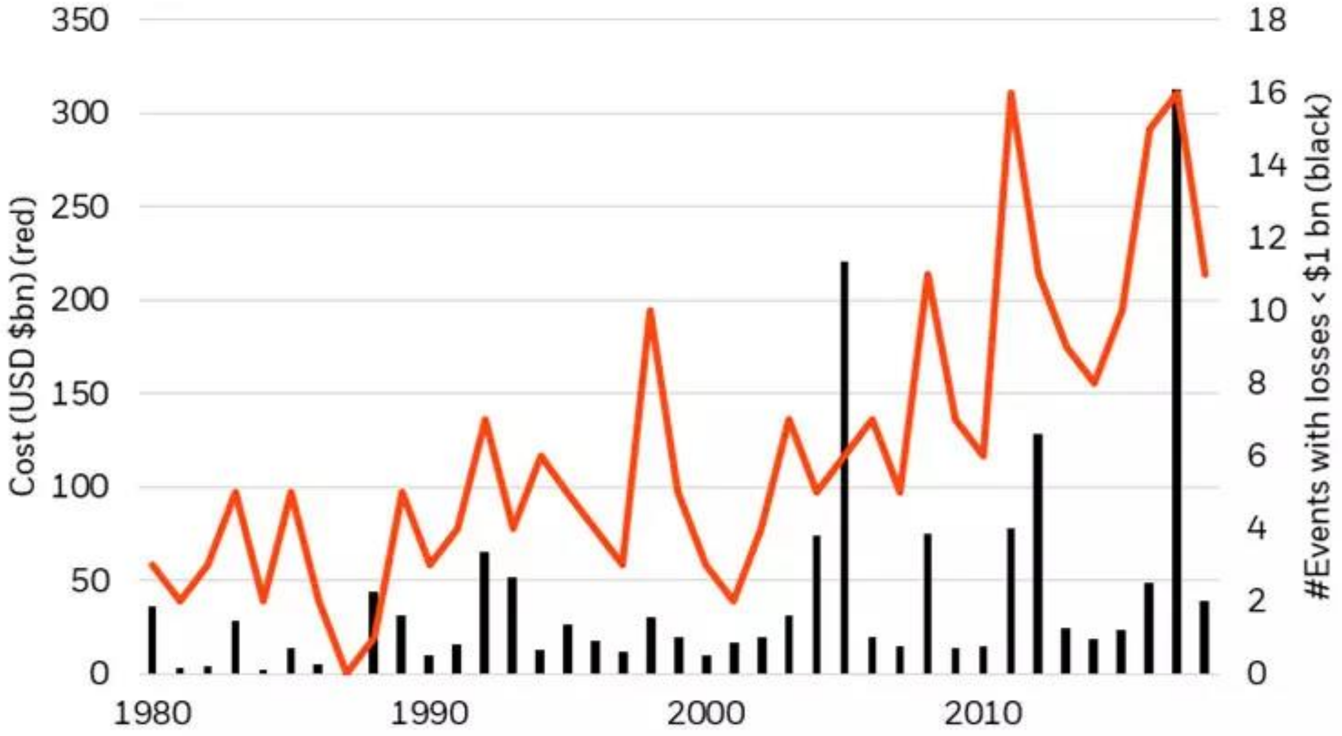


Source: ESCAP

- **Access to capital is critical** to the transition to net zero.
- **Cost of capital is rising** – how will this impact financing considerations and what does it mean for sustainable financial instruments?
- Some commentators have argued that current market conditions could increase the speed of transition.
- What is the role of concessional and blended financing and mechanisms such as the Just Energy Transition Partnership (JETP) or BlackRock blended finance climate fund in catalyzing sustainable finance in this environment?

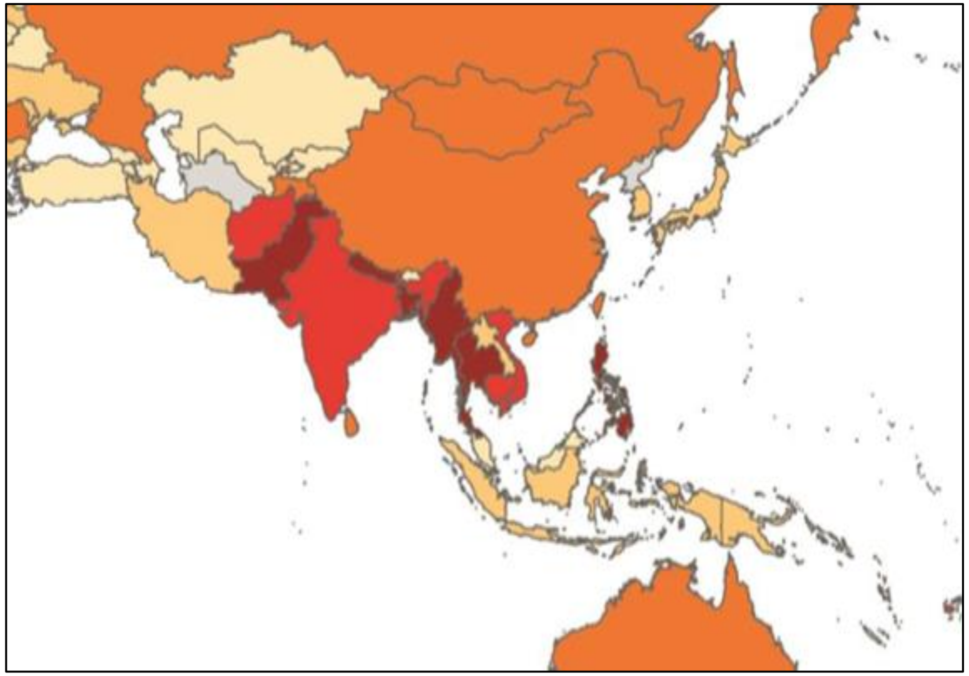
.. Increasing Climate Change

Extreme weather events have increased drastically in the last decade, leading to higher costs



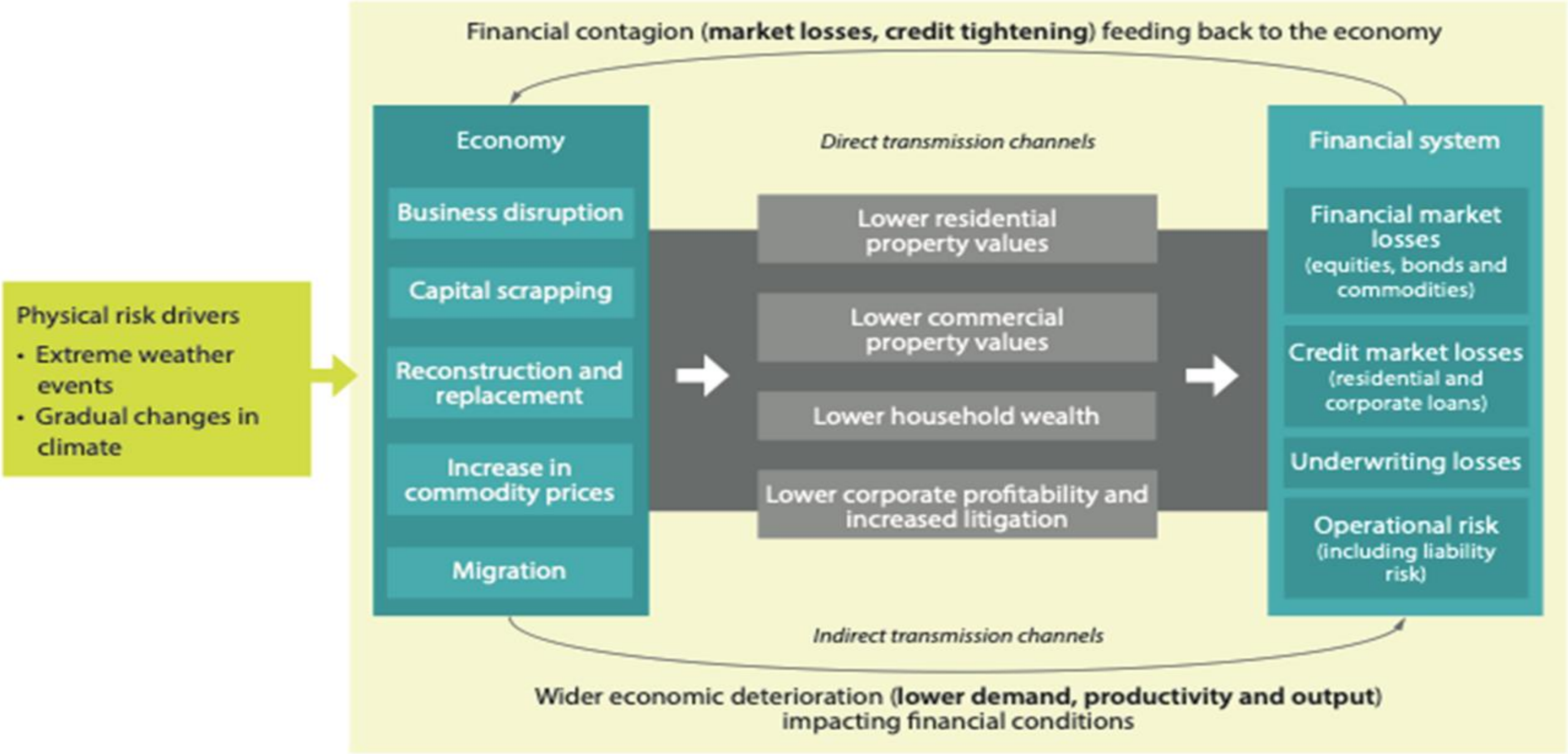
Source: Munich RE, Record hurricane season and major wildfires – The natural disaster figures for 2020, as of January 7, 2021.

Increasing Relative Exposure to Extreme Weather Events



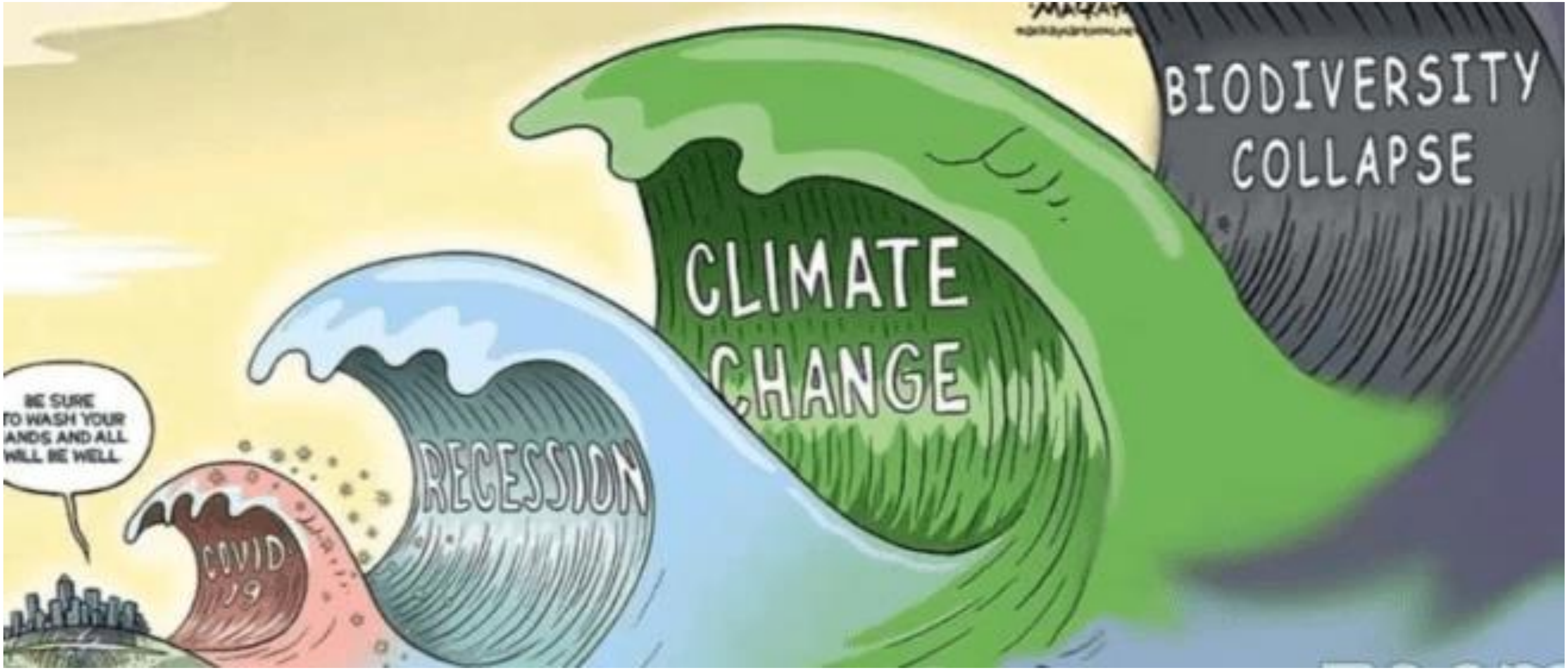
Source: Germanwatch and Munich Re, in GLOBAL CLIMATE RISK INDEX 2021

.. Adding to increasing physical and transition risks due to climate change



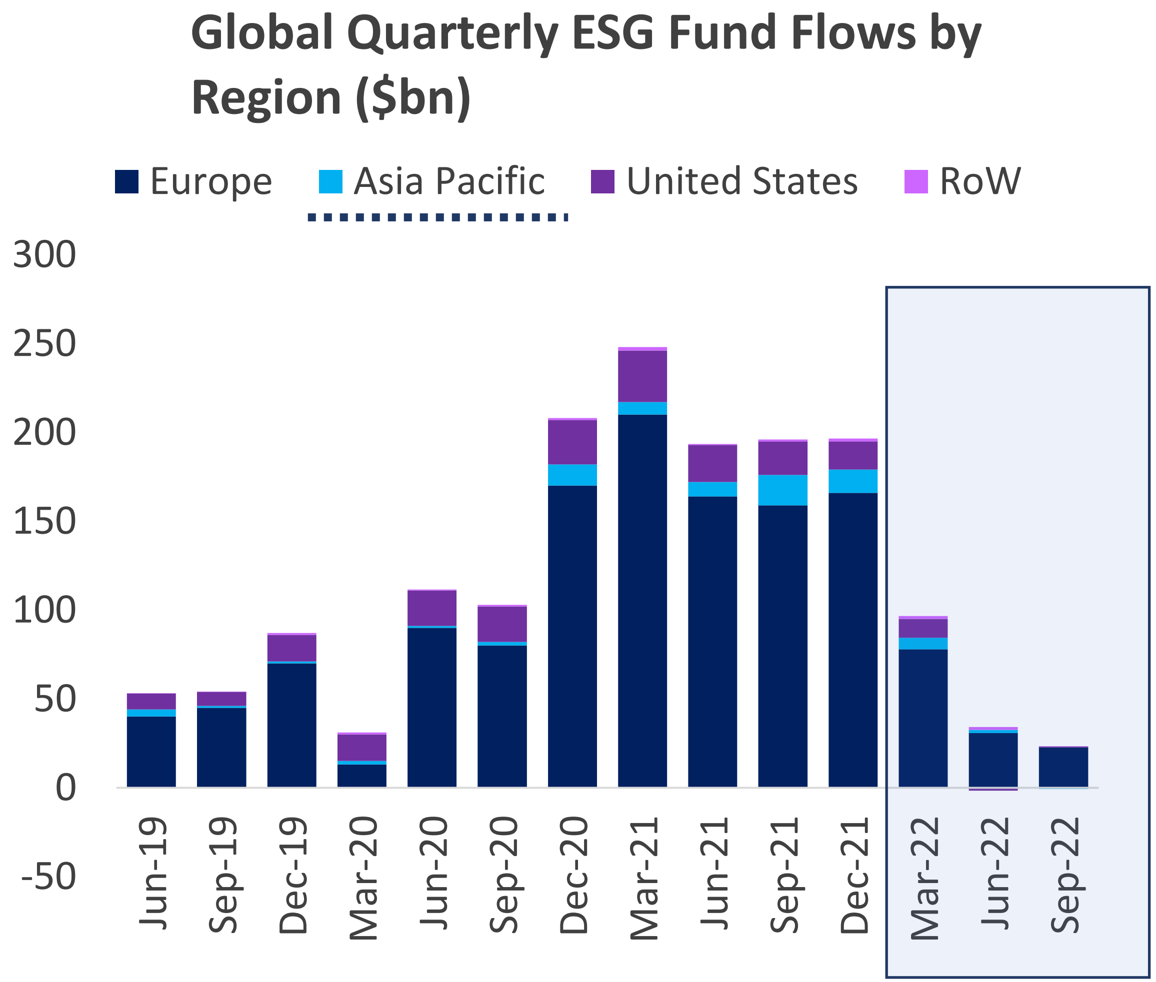
Source: A call for action, climate change as a source of financial risk, NGFS April 2019

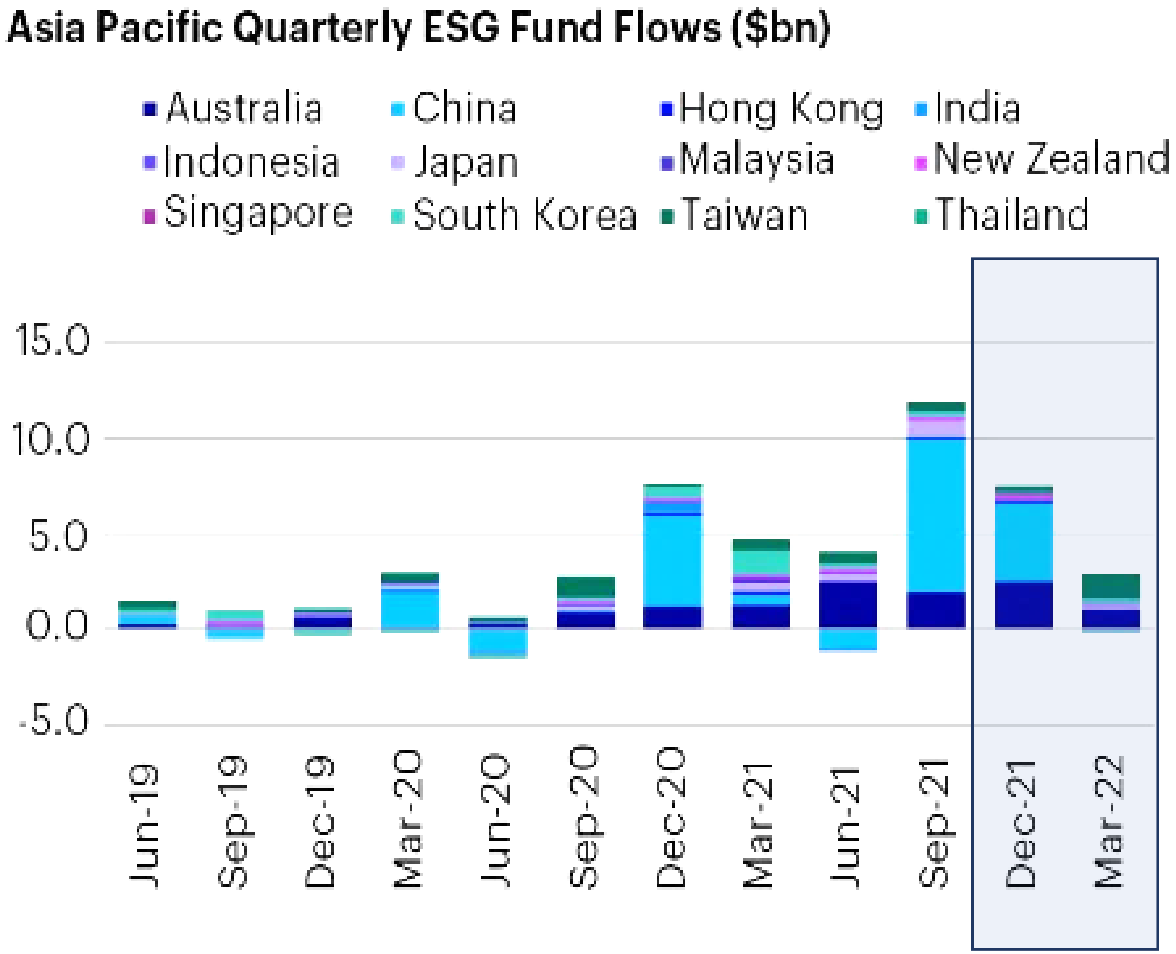
Sustainable Finance - Now or later?



2. How Can Innovative Instruments Expand the Flow of Sustainable Finance Through Capital Markets?

The rise of sustainable finance fund flows



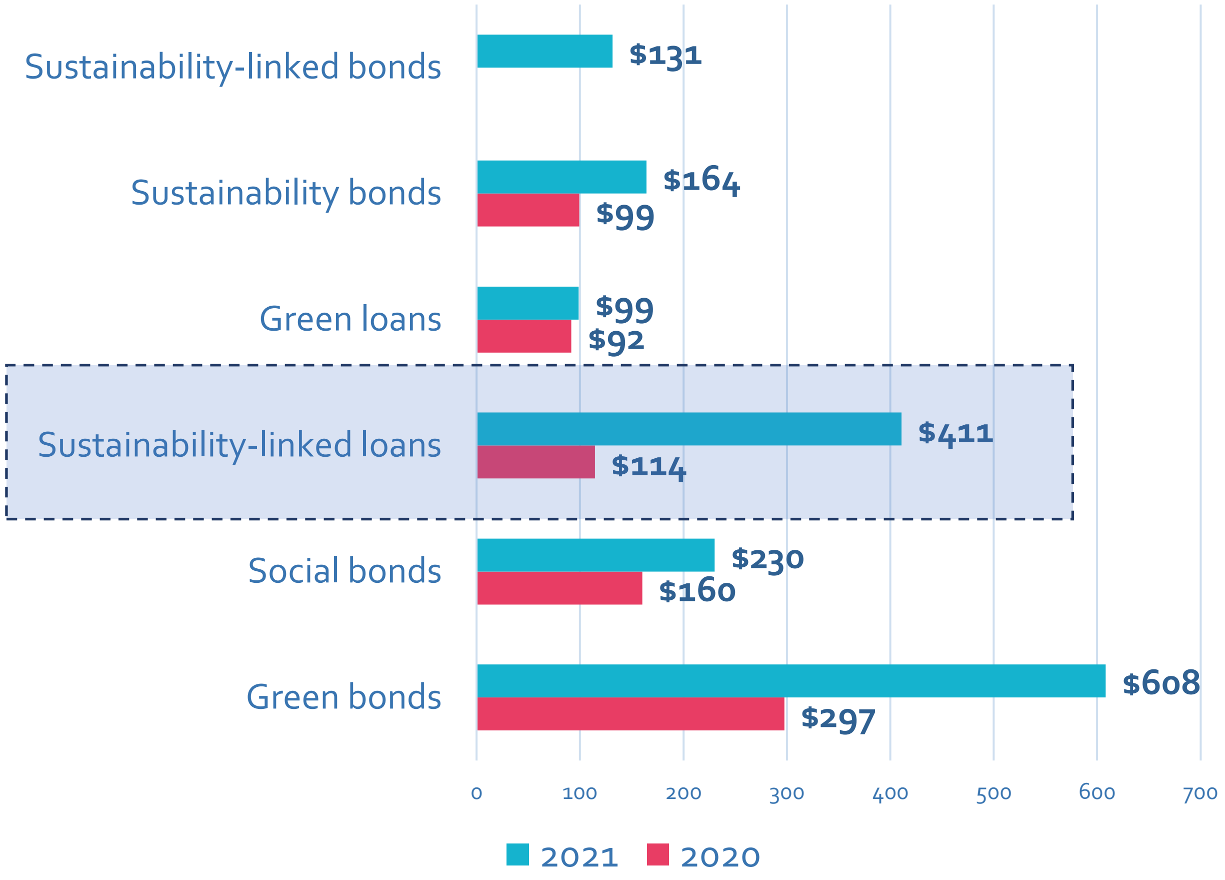


Source: Morningstar, Morgan Stanley

What can banks, issuers and investors do: trends and challenges

Trends

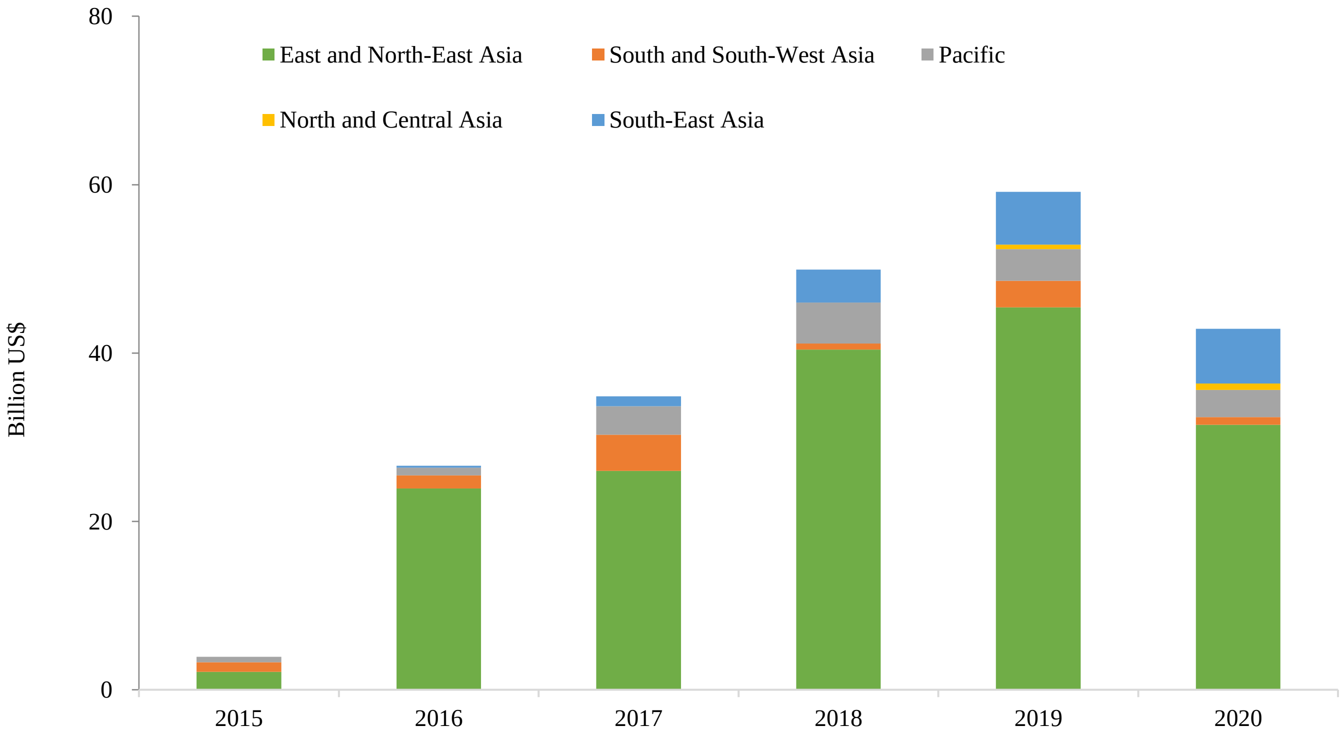
2021 Global Sustainable Debt and Loan Instrument Issuance (USD bn)



Challenges

- While the region has **substantial overall growth** in sustainable debt, **LDCs and SIDS are largely excluded.**
- **Lack of developed capital markets** and institutional capacity in several countries
- **Weak regulatory and policy frameworks** in several countries
- High real and perceived risks create a **bankability gap** in potential investment
- **Low-Risk Appetite of MDBs** and Bilateral DFIs

What can banks, issuers and investors do: GSS+ Bond Trends



The green theme is still the largest source of debt, with 49% of the total but SLBs demonstrated the fastest growth, expanding by ten times year-on-year

Source: ESCAP based on data from Climate Bond Initiative (CBI) and International Capital Market Association (ICMA).

Why the lack of Sustainable Debt Markets in SIDS and LDCs?

Is Fiji's Green Bond the exception that proves the rule?

Source: Government of Fiji

Challenges

- Lack of sizable investment projects
- High relative costs
- Rising debt distress
- Underdeveloped and Illiquid capital markets
- Lack of risk management tools, e.g. FX hedging
- Lack of awareness and institutional capacity
- Lack of regulatory and policy frameworks
- Difficulties integrating Nature Based Solutions

3. Key Recommendations

What can banks, issuers and investors do: opportunities

- Developing Sustainable Loans
- Prospects for Sustainability-linked Loans
- Building Sustainable Industry Standards
- Embedding Sustainability in the Credit Process
- Improving Cost of Capital

- This includes setting "***sustainability performance targets***" for borrowers . If these targets are met, the borrower is rewarded with reduced loan interest rates.
- Strong potential to open the sustainable loan market to companies in a wider variety of sectors and smaller companies/SME

Carbon Offset Markets in LDCs and SIDS

- Aim to enable companies and governments to meet their emission reduction targets by purchasing carbon offsets
- Allow to measure reductions in GHGs based on certified standards
- Strong potential in SIDS and LDCs (focus on nature-based solutions and climate mitigation)

Recommendations for banks, issuers and investors

Improving international integration	**Peer-to-peer learning networks** to support cascading knowledge and raising standards (such as UNEP-FI Principles of Responsible Banking, Principles of Responsible Investment, and Principles of Sustainable Insurance)
Strengthening domestic collaboration	**Development of localized standards** for sustainable and sustainability-linked loans by sustainable finance working groups **Standardization of securities** around principles aligned with the **Climate Bonds Initiative or the International Capital Markets Association** to improve the liquidity and appetite for sustainable bonds
Developing financial sector infrastructure	**Technical assistance to credit institutions** on how to build sustainability and ESG risk management.
Incentivising sustainable economic development	**Use of sustainable and sustainability-linked loans**, particularly among smaller companies and across diverse economic sectors
Mobilising sustainable finance	**IFIs support to private credit institutions or local DFIs** by investing equity in the FI; and/ or buying bonds issued by the FI; and/ or extending credit

Recommendations to strengthen carbon pricing in Asia Pacific

Improving international collaboration

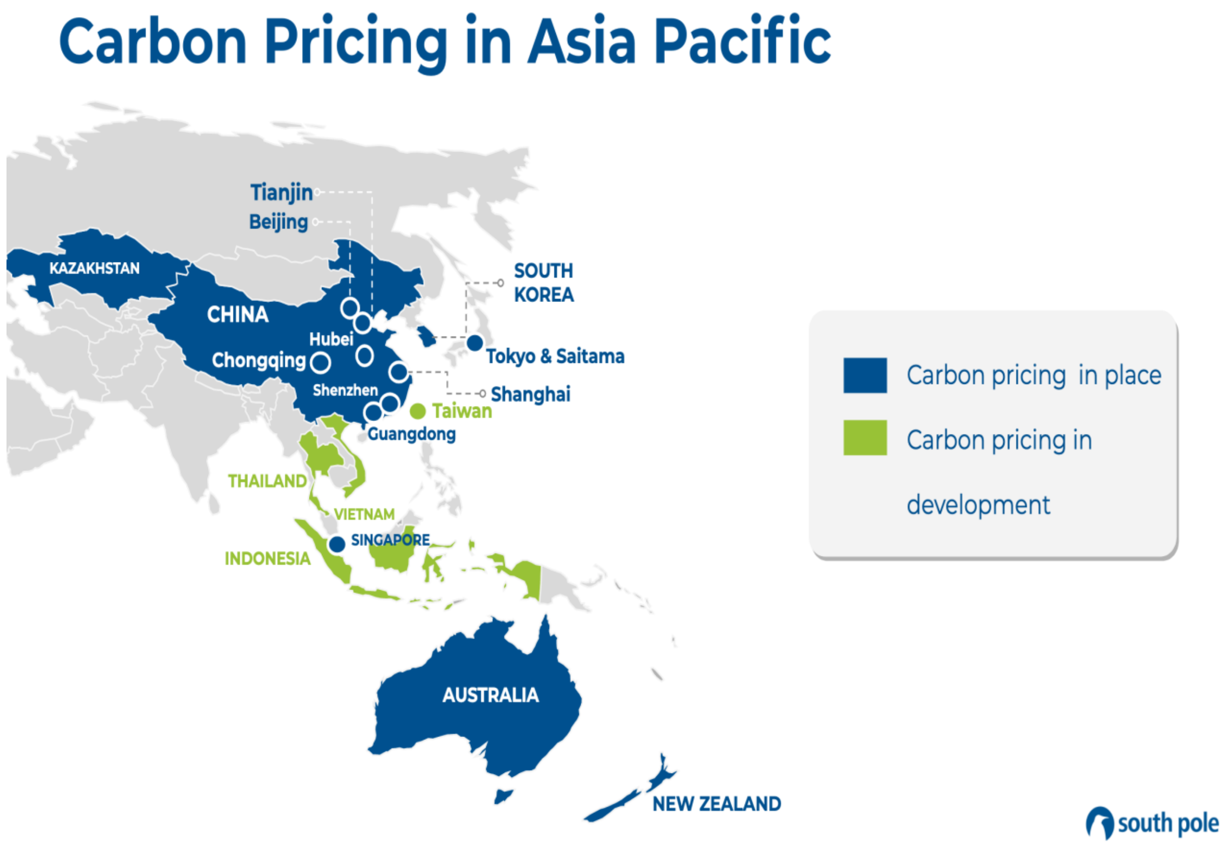
Peer-to-peer learning networks to support knowledge exchange and harmonize rules to support further development of international voluntary and regulatory markets under Article 6.

Strengthening regional collaboration

Support countries in the region to **develop and strengthen regulatory frameworks** to engage with Article 6 and ensure market integrity. **Examine co-design of regional offsets programs.**

Developing technical capacity building

Technical assistance to raise awareness and support institutional capacity building particularly in LDCs and SIDS



4. Expert Discussion

Questions for discussion

1. The recently released Sharm el-Sheikh Implementation Plan calls for MDB shareholders of MDBs to reform MDB practices and priorities and to define a new vision and operational model, channels and instruments that are fit for addressing the climate emergency. What are the **most critical changes needed** to move towards this new vision and operations model, and what channels and instruments, in your view, will be most crucial in improving private sector green investment in the Asia Pacific region?
2. How will the current **macroeconomic environment (increasing debt levels and interest rates) and decreasing volumes of capital flows** impact sustainable finance in the region moving forward – is this a long-term trend? Are there debt alternatives that should be considered?
3. In many Asia-Pacific economies investors claim that there is a **shortage of investable green projects**. What are your recommendations to better support the development of sound pipelines of bankable green projects? How can we effectively scale up blended finance to support the flow of investments toward such projects?
4. Sustainability and climate considerations are critical to long-term financial sector stability. What **policies and incentives** should be considered to support the financial sector to move towards a sustainable finance agenda?
5. What new and exciting financial instruments are you seeing in the market that can address the climate and sustainable financing gap? (e.g. carbon offsets, etc.)
6. Overall comments and considerations to be further included in the report?

ESCAP

MOVING FORWARD TOGETHER