Seventh Annual Meeting of the San Giorgio Group

SUMMARY

On March 21 -22, 2019, at the seventh meeting of the San Giorgio Group in Venice, Climate Policy Initiative brought together key financial institutions and intermediaries actively engaged in green, low-emissions finance for frank discussions on the most pressing policy and investment issues related to scaling up climate action. The San Giorgio Group is organized in collaboration with the World Bank Group, China Light Power, and the Organisation for Economic Co-operation and Development.

The following summary provides key insights from the discussions, summarized by topic. Comments are not attributed as discussions take place under Chatham House Rules.

THE BIG PICTURE – ARE WE AT THE CUSP OF A GREEN FINANCE TRANSITION OR AT THE EDGE OF A CLIFF?

Despite progress over the last decade, we need a reality check to address the elephant in the green finance room: speed and scale. The Paris Agreement has brought together a variety of stakeholders behind climate action. There is now more momentum towards a systemic transformation, driven by, amongst others, progress in technologies, in regulatory achievements, in mainstreaming green finance into funds and financial products, and increased overall awareness. On the private sector side, corporations are more in tune with the current impacts and risks in their supply chain and markets and taking action. More generally, investor awareness is starting to manifest beyond ESG risk management to activism. 20% of shareholder resolutions in this year's proxy season are climate-related.

However, the green finance world remains relatively boutique, triggered by several issues, including:

- Silos in the donor community across different sustainability issues that hinder an inclusive approach to financing impact.
- A lack of appetite for risk among donor finance, that leads to finance flowing to sectors or projects with easy wins, rather than in more difficult areas.
- Concessional finance providers that are less flexible in addressing a spectrum of risks, and now require their capital to be protected.
- Public finance that remains too slow to work with the private sector, resulting in deals taking too long for the related costs.

Overall, there is a clear need for yet more leadership and it's time to take the spirit of the Paris agreement seriously in order to achieve net zero global emissions by midcentury.

HOW TO MOVE FROM THE $100 BILLION TO ALIGNMENT?

Aligning financial flows with the goals of the Paris Agreement sounds simple in theory but is difficult to put into practice. For alignment to be achieved, all financial institutions will need to greatly reduce "brown," or high emissions investment, and mainstream climate considerations across their assets. This discussion focused particularly on the role of governments and development finance institutions (DFIs), noting several recommendations:

- Prioritize country needs. Donor governments and DFI's have the opportunity to work closely with recipient countries to meet targets, and in some cases, strengthen such targets by providing targeted technical assistance and financial instruments fit for specific national contexts and barriers.
- Use capital effectively. DFIs need to increase their risk appetite, using public capital more effectively to help transform the more challenging sectors and crowding in private finance. Public financial institutions also need to further develop financial vehicles and instruments that factor in a larger set of risks and returns, including long-term viability, stranded asset and climate risks.

- Do no harm. DFIs will increasingly have to take decisions on projects misaligned with Paris but that are within a country's economic development priorities – of which coal and gas generation, and non-resilient infrastructure are the most critical. Some DFI's are approaching this through a "do no harm" KPI.
- Transform the institutions. Incentives must be in place to give investment officers greater credit for financing aligned activities, i.e. through larger climate weightings in project assessments.

Overall, governments play a key role to enable alignment, both by increasing climate-linked funding and influencing the mandates and abilities of public financial institutions to do the same.

GREEN BANKS: A REAL POSSIBILITY OR A LONG SHOT?

Specialized institutions can help trigger systemic change, but no one size fits all. Green banks are beneficial in that their structures can vary greatly depending on the country context, but typically are either a standalone institution, an add-on to an existing, private institution, or an add-on to a development finance institution. Standalone institutions, built from scratch, can define objectives from the outset for long-term success. They may also step in where there is an institutional framework failure, for example a government failing to provide utility services. However, in some countries, it may prove to be more efficient to mainstream climate action into the operations of existing institutions rather than establishing new institutions.

Regardless of its structure, elements of a green financial institutions' success are defined by its:

- ability to raise funds
- capacity and skillset of staff
- credibility
- political leadership

Above all else, though, the key to building capacity to run effective green financial institutions is country-to-country and institution-to-institution cooperation.

CLIMATE FINANCE FLOWS – QUO VADIS?

To achieve capital asset transformation, we need more than an increase in green flows. With processes such as the Global Stocktake related to implementing the Paris Agreement, new framing for measuring progress may be necessary to ensure that not only are we reporting finance flows but also whether the financing is achieving what is required. These include:

- a focus on capital stock transformation to provide a frame as to whether new financing is resulting in emissions sources being retired and replaced at the required rate;
- a focus on the next frontier of investments needed to bend emissions curve on a sector by sector basis.

In all cases, understanding which financing into capital stock or assets needs to be reduced is an important element to include within the frame of measuring progress. Brown financing may be classified as investment in a brown project when a green alternative is credibly available. However, due to the many sectors currently struggling to produce a green alternative, there is still value in focusing on reducing the carbon impact of existing technologies, particularly in the heating and industrial sectors.

A focus on impact is also relevant when analyzing finance for broader sustainability goals, such as universal energy access. Speaking to specific uses and services of what the finance is enabling allows for appropriate policy reforms and systemic changes to be proposed.

ADAPTATION AND RESILIENCE – CLIMATE RISK OR OPPORTUNITY?

There is an urgent need to spur greater investment into climate adaptation and resilience, in both the public and private sectors. Adaptation is not an incremental, climate proofing problem – we need to look at it as a total transformational shift, similar to the low-carbon transition. However, current investments in adaptation constitute only a fraction of what is needed to avoid costly and catastrophic future impacts and progress in adaption and resilience finance over the last two years has been incredibly slow. To begin to tackle climate risks from a financial perspective, we face two urgent needs.

- First, we need to better take on the opportunity of resilient assets. For this, we need better products and better outcomes across the entire adaptation and resilience sector that can begin to build record of success from which to scale. While there are already great instruments out there, they need more capital, and soon.
- Second, we must better price the risk. Financial institutions need to move quickly to factor climate risk in their decisions, and price it correctly to ensure informed decision making by investors. Comprehensive analysis of climate risk

assessments and its alignment with both Article 173 in France and the Task Force on Climate-related Financial Disclosures' recommendations is crucial. It is often seen that the mispricing of climate-related physical risks, in turn, results in mispricing of assets, misallocation of capital, and raises questions of financial stability of the business. However, once investors observe valuation risk they will respond very quickly.

Many barriers will need to be overcome within companies to adapt to this change. These include:

- internal capacity building;
- developing a financial case for adaptation; and
- understanding how to tranform supply chains and systems.

As institutions work to make progress on both of these major challenges, unfortunately, conversations in this sector are often happening in silos; there is also an urgent need to bring different stakeholders together.

SUSTAINABLE LAND USE FINANCE – HOW TO MAKE IT HAPPEN?

If we do not get land use right, all other efforts will be in vain: reducing the encroachment of agriculture on forests is crucial for climate change mitigation. How to protect forests is no secret, but the main sticking point remains who pays for the protection. Commercial models are needed which go beyond "do good" motivations. Private finance is still quite rare in the sector. Carbon markets have not materialized sustainable land use finance at sufficient scale and while there is interest from private investors who want to make an impact, there is a lack of investable pipeline and sophistication in opportunities which effectively blend public finance and are also attractive to mainstream large scale private finance.

Some promising examples of blended, replicable, and commercially viable sustainable land use finance initiatives include:

- The Natural Capital Financing Facility, run by EIB, is a EUR 120m fund guaranteed by 50m from the European Commission, which aims to demonstrate how natural capital financing can be profitable in Europe. As one example, a EUR 5m loan has been provided to the Athens municipal government to introduce green infrastructure for cooling and resilience.
- The Responsible Commodities Facility is a debt fund which provides low interest credit lines to zero deforestation soy farmers in Brazil using capital raised on the international green bond markets.
- A platform called the Forest Reserve Credits, is being developed to promote compliance with the brazil forest code. Environmental conditionality is a key solution. There are opportunities for governments to integrate environmental conditionality into their own spending. For instance, the Brazilian government provides 30 million subsidies to farmers each year, but does not yet attach environmental conditionalities to that support.
- Models are being tested to have hydro operators and mangrove beneficiaries pay. In such models, co-benefits, those related to employment for example, can also captured and monetized. Owners and operators of infrastructure in sensitive locations and heavy natural resource users, such as oil and gas companies, are also potential sources of conservation finance given their commercial nature.

While numerous initiatives exist to incubate promising sustainable investment business models, efforts are often fragmented and disjointed from potential private investors, highlighting the need for strengthened collaboration efforts rooted in the private sector, and provision of bridge capital to get large scale ideas off the ground.

BLENDED FINANCE – HOLY GRAIL OR LIMITS TO USEFULNESS?

Blended finance is arguably one of the most promising tools to mobilize private capital for climate action. However, the current blended climate finance stock, globally, is still relatively small, around USD 48bn over the past few years, and leverage ratios could be much higher, as per a recent study by Convergence.

Some promising examples of blended finance initiatives include:

- Indonesian Tropical Landscapes Finance Facility, which is aimed at attracting institutional investor capital in to large-scale restoration, sustainable agriculture, and renewables.
- Finance in Motion public-private partnership structured funds have grown to a USD 1bn platform of public capital under perpetual management – allowing investment of USD 12bn in energy efficiency, agroforestry, and microfinance in various geographies. Profits are then reinvested into technical assistance for capacity building.

- EIB portfolio shows the importance of sharing knowledge with the private sector. Last year, EUR 750m of equity investments leveraged EUR 20bn in capital at the fund level, and in turn, USD 60bn of investment on the ground.
- Long-Term FX Risk Management is an instrument from the Lab that transfers currency risk into its global risk pool for currency risk via swaps and forwards for investors. It is very scalable, and increased scale minimizes risk exposure and attracts larger investors. So far, it has hedged USD 240 mn of climate-related investment in 11 countries.

Much can be done to improve the effectiveness of blended finance. Priorities in this space include:

- Aggregation and scale. Large blended vehicles or megadeals are needed rather than a project-by-project, transaction-by-transaction approach.
- Geographic reach. There are many good deals for the private sector in Europe, but not in Africa. This needs to change.
- Incubation and acceleration. Grants and patient capital are needed to develop transactions, support the teams behind them, and get blended finance deals to market. However, a venture seeking approach with a commercial mentality is needed. Examples of this include Convergence and the Lab, which also provide independent technical advice for donors and investors.
- Repurposing structures. Rather than innovation for innovation sake, existing financial instruments can be repurposed and appeal more to private investors, who are already wary of technology risk and do not need additional risks from creating something new in financing, too.
- Risk taking by DFIs. DFIs could do more with existing balance sheet structures to take more junior risk positions. But to do this, internal incentives, structures, and mandates need to change, and DFI principles have to be more rigorously implemented and independently monitored.
- Structuring driven by the private sector. While most blended finance deals are currently structured by MDBs, the private sector could structure the deals and take more of a risk return perspective.
- Support the private sector. Subsidizing the private sector raises concerns, but support is essential given climate needs. Furthermore, risk needs to be priced to attract, not crowd out, the private sector.

SUSTAINABLE CITIES – HOW TO CLOSE THE GAP BETWEEN AMBITION AND INVESTMENT?

The world's one hundred largest cities are on track to exhaust their own carbon budgets by 2025, and will use the entire world's carbon budget by 2060. The expectations placed on cities since COP21 have also skyrocketed on a political level. Yet, the link to finance for such actions in emerging market cities is still missing.

Alignment between municipal and national political agendas for cities climate finance is critical. Cities in many emerging markets often have little control over budgetary resources, depending on central government transfers for over 80% of revenues, and dividing the few discretionary resources among multiple other spending priorities, including housing, health, education, and water. In addition, while climate preparations have accelerated in cities, they are rarely connected to the financial instruments needed to execute them. In addition, political windows for implementing projects are very small, with mayors changing frequently and high risks of policy reversal or loss of political will. To attract investor interest, cities also need to move from a project-by-project approach to a sustainable infrastructure framework that is responsive to new information and technologies.

These barriers can be addressed in several ways:

- Greater integration between technology, climate preparation, and finance in cities. To help design and expand the range of instruments available for this purpose, development finance providers should pay closer attention to cities' fiscal circumstances, particularly their revenue flows and tax collection.
- Greater focus on ideas with other environmental co-benefits or cashflows to gain political traction. Performance-based air quality instruments, for example, can reduce healthcare costs and public health burdens, while also engaging citizens more directly by financing popular transport electrification projects and generating private sector interest through the monetization of avoided costs.
- Greater pace of innovation. Progress can be accelerated by learning the lessons from success and failure stories of coalitions of actors in a more standardized way. Fostering a platform for collaboration can support this path. The French and German governments are taking steps in this

direction through the revival of the Cities Climate Finance Leadership Alliance (CCFLA), with CPI as its Secretariat.

FROM RISK DISCLOSURE TO ACTION

For years, environmental, social, and governance (ESG) reporting has lacked structure and cohesion and has been reported only under voluntary private standards. This is changing for climate change considerations with the Paris agreement, the French Article 173, which introduced a comply or explain approach by having investors describe methods for incorporating ESG factors in their investment strategies, and the European Commission's non-binding disclosure guidelines, amongst others. These efforts, however, represent a cutting edge, and much more consideration will need to be taken, including:

- Risk is both dynamic and disruptive and renders nonlinear changes, which are difficult to assess and regulate from an investor perspective. One cannot narrow it down to a single metric, where a company's carbon footprint, or the weather-related risks of a two-degree global warming scenario can provide clear cut answers.
- We need a comprehensive mapping of multiple forces, including climactic, regulatory, political, business, and individual/consumer.
- The key to making informed capital allocations lies in understanding the various risks and opportunities associated with climate change, as well as the shifting preferences of shareholders and consumers.
- It may be more impactful to regulate the corporations instead of the asset managers to shift capital allocation decisions towards a green transition.

While governments and institutions are becoming increasingly active in providing frameworks and regulatory action for climate-related financial disclosures as well as sustainable financial products, a key missing piece is policy predictability, especially in times when the pace of regulatory change is fierce. At the same time, certainty on physical risks continues to increase with climate change related bankruptcies (e.g. PG&E). This is concerning given a huge insurance gap for physical risks, as a large amount of assets are not insured, especially in developing countries. There is a clear need to develop capital market-based solutions to transfer appropriate risk from governments to businesses.

Overall, there is a need to change the narrative from risks to incentives. A first step here will be to identify the right incentives which are driving investors and corporations to disclose climate-related financial risks and impacts, something more than downgrading concerns.

CONCLUSION

All of this, in turn, points to a **net zero carbon emissions finance imperative:** every aspect of the world's financial system, from corporate and municipal bonds to securities regulation and stock market listing requirements, and other levers—from fiscal stimulus to trade agreements—must be harnessed to achieve the needed transformation over the next three decades. It's time to walk the talk – and to stop taking no for an answer. At CPI, we remain committed to supporting this pathway, together with all our partners. We thank all our participants from the 7th San Giorgio Group meeting for their excellent and very open contributions to our discussions..