Nick Robins November 14th, 2022

The $468 trillion climate question: how the financial system is starting to shift

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***Nick Robins** writes from COP27 on the steps being made to transform finance for a net-zero and resilient world.*

This article is part of a series by LSE's Grantham Research Institute on Climate Change & the Environment (visit website).

In the end, every climate conference always comes down to finance and COP27 in Sharm El Sheikh is no different. With $468 trillion in assets across the globe, there is no shortage of cash to prevent climate harm, decarbonise the world's energy and land use systems and ensure societies can adapt to mounting physical impacts. The problem is that the priorities, rules and incentives that govern both public and private finance have long been pointing in the wrong direction. This means there is a "persistent misallocation of capital", in the words of the Intergovernmental Panel on Climate Change. This is an especially burning issue for the world's developing countries, which have contributed least to the climate problem and are already suffering real human and economic costs.

A systemic transformation of finance is required

The latest UNEP Emissions Gap report tells us that a "wide-ranging, large-scale, rapid and systemic transformation" is needed, and that includes the world of finance. Two tightly intersecting financial imperatives are coming together at COP27 – the longstanding commitment from 2009 for industrialised countries to provide $100bn a year in climate finance to developing countries by 2020; and the goal to make financial flows 'consistent' with net zero and resilient development.

The $100bn goal covers both public and private finance, but the vast bulk of this international climate finance is from governments and public development banks. Compared with the GDP of industrialised countries, $100bn is a tiny amount and the failure to honour the 2020 commitment has soured climate negotiations and undermined trust. The current projection suggests the pledge will eventually be met in 2023. In addition, the quality of climate finance needs to shift more from loans to grants, to make access and deployment easier and to get a better balance between decarbonisation and resilience. Latest estimates show that adaptation finance flows in developing countries are five to 10 times below estimated needs; industrialised countries have committed to double adaptation finance to $40bn by 2025.

The second imperative is the Paris Agreement goal to make align financial flows with climate goals (Article 2.i.c). This shifts the financial focus from the tens of billions to the hundreds of trillions, and means that the fundamental rules of the game have to be changed so that every financial decision is climate-consistent.

COP27 would seem a tough place to make progress on transforming the financial system. The 2022 polycrisis, with compounding geopolitical, energy, food, inflation and public finance crises, is diverting attention and leading some to turn back towards fossil fuels. Egypt's Minister of Foreign Affairs, Sameh Shoukry, has underscored the "insufficiency of climate finance" and warned about "backsliding on delivery of finance pledges". Yet, the crises of 2022 are also adding to momentum to speed the shift to an efficient and renewable energy system and reinvest in the natural systems that underpin food security and resilient infrastructure.

Emerging progress at COP27

COP27 can't and won't solve the $468 trillion climate question: that's not its purpose. But even before the conference has completed, encouraging movement is taking place on at least five fronts.

Signalling the need to reform the global financial architecture

At COP, leading voices from governments and from the financial sector have pointed to the need for system change. Barbados' Prime Minister Mia Mottley has set the pace with her Bridgetown Agenda to overhaul the global financial architecture. In the first week of COP, Mottley proposed "the establishment of a climate mitigation trust that unlocks $5 trillion of private sector savings". From within the financial sector, the CEO of Aviva Investors Mark Versey described the global financial architecture as "not fit for purpose". The weeklong dialogue at COP of the Global Stocktake highlighted that this means finance ministries have to be in the driving seat. Right on cue, the Coalition of Finance Ministers for Climate Action, with more than 75 members across the world, opened a consultation on the pivotal role of finance ministers.

Laying out the roadmap to scale up international climate finance

With a new climate finance goal needed from 2025, COP27 became a place to think how to go beyond the $100bn benchmark and scale up international climate investment into developing countries. The details of what a transformational plan could look like came in the form of the *Finance for Climate Action* report prepared by Dr Vera Songwe, Professor Lord Nicholas Stern and Professor Amar Bhattacharya at the request of the Egyptian and UK COP presidencies. The report sets out how to channel $1 trillion a year in international public and private climate investments into the developing world by 2030. This would involve tripling the annual flows from multilateral development banks in the next five years, and doubling concessional finance from developed countries by 2025 from 2019 levels. Rising indebtedness also needs to be confronted, and here developing countries have proposed a grand-scale climate-debt swap to cut debt payments in return for spending on their own plans for climate resilience and prosperity.

Doing the deal on loss and damage finance

The 55 developing countries that are part of the Climate Vulnerable Forum have calculated they have lost 20% of their national income in the past two decades because of climate impacts. After years of pressure, COP27 could well be the place where governments finally agree to establish a dedicated fund to finance loss and damage initiatives. This would be built on the core principles of 'common but differentiated responsibilities' and pay for the unavoidable or unprevented loss and damage that does not otherwise qualify for adaptation funding. At the Paris COP in 2015, governments agreed that loss and damage does *not imply liability or involve compensation and industrialised countries have tended to resist substantive progress based on concerns about unlimited financial exposure. Symbolic pledges of loss and damage finance from countries such as* Scotland *and New Zealand could help to inspire the way to a deal.*

Getting private finance to deliver net zero with impact and integrity

COPs are no longer simply about public finance and policy: reallocating the private capital that makes up the bulk of financial system assets is essential. At COP26, as part of the Glasgow Financial Alliance for Net Zero (GFANZ), over 450 institutions with $130trn in assets committed to align their portfolios with net zero by 2050. The number has since grown to more than 550 institutions and guidance has been issued on how they can deliver credible net zero plans to phase out high-carbon activities and ramp up finance for climate solutions through a just transition. Here, COP27 marked a critical shift in the net zero finance agenda from a primarily voluntary approach to one that will increasingly involve mandatory disclosure and regulatory oversight.

In Sharm El Sheikh, the Integrity Matters report from the UN Secretary General's high-level expert group on net zero recommended that regulation is needed to level the playing field for the design and implementation of net zero transition plans in order to drive out greenwashing. This chimed with the release at COP of the first frameworks from the UK's Transition Plan Task Force, which will inform future regulation to make disclosure of net zero plans mandatory. Central banks and prudential supervisors are also set to get involved so that net zero plans really address the misalignment of financial assets.

Making sure finance is delivering climate action through a just transition

Principles of justice and equity lie at the heart of financing climate action, in terms of fairness both between and within countries. At COP26, the announcement of South Africa's just energy transition partnership (JET-P) was a practical example of what this could involve. At COP27, South Africa came back with a concrete just energy transition investment plan to ensure that those most directly affected by the transition away from coal are not left behind, and that people also benefit from the growth of new green sectors in energy, industry and transport. The plan identifies $98 billion in financial requirements over the next five years from the public and private sectors, of which an initial $8.5bn will come from international partners including the EU, UK and USA. Other JET-Ps are now underway in countries such as Indonesia and Vietnam.

The Egyptian Presidency also signalled the importance a just approach to finance, bringing together international best practice (particularly from development banks) into its Sharm El Sheikh Guidebook for Just Financing. More and more private financial institutions are also working to make sure their climate strategies embed just transition principles. The International Labour Organization's 2015 just transition guidelines provide the foundation for this. At COP27, the ILO and LSE's Grantham Research Institute released a Just Transition Finance Tool to show how banks and investors can make the social dimension core to their climate efforts. A just transition approach in nature is also vital to end deforestation and boost regenerative agriculture in ways that support local communities and the rights of Indigenous Peoples. This agenda is set to move forward quickly, not least following the election of Luiz Inacio 'Lula' da Silva as the new President of Brazil.

Beyond the comfort zone

Finance is still largely misaligned with climate change goals. The steps forward so far – including those at COP27 – are provisional and do not yet amount to an irreversible shift towards a sustainable financial system. It is clear that a 'finance as usual' approach will not work: transformational approaches are needed. As LSE's Director Minouche Shafik underscored at the COP opening ceremony, success will require all forms of finance to "stretch beyond their comfort zones". Unusual allies for ambitious climate action are, however, emerging: from central banks to finance ministries, from development banks to commercial banks and from institutional investors to insurance markets. Making the breakthrough will involve sustained leadership from both developed and developing countries.

Watch Nick Robins' YouTube short on transitioning to a net-zero economy.

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Notes:

- *The author thanks Brendan Curran, Simon Dikau, Anika Heckwolf, Hans Peter Lankes, and Rob Macquarie for inputs and comments on this commentary.*

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