CLIMATE, BIODIVERSITY AND CLIMATE CHANGE

Sustainable Economy: A Risk to Calculate

- *Public Development Banks (PDBs) face challenges aligning their financial viability with environmental and social objectives.*

Cartagena (Colombia), September 4, 2023. The world needs more advanced, technological, and flexible mechanisms in predicting, measuring, and impacting investment to adapt to and mitigate climate change. These mechanisms should lead to the best possible balance between the Paris Agreement and a zero-emission economy.

This was one of the central points of discussion surrounding climate, biodiversity, and climate change during the Fourth Common Finance Summit held in Cartagena, Colombia. The Summit emphasized that, although the discussion doesn't start from scratch, it requires more technology and a joint understanding that climate and nature-related risks are interconnected.

Furthermore, it highlighted the need to create a collective awareness that, no matter how simple, all economic activities worldwide must be mitigated and made sustainable. This entails gradually and systematically replacing major emission sources.

Public Development Banks (PDBs) face challenges aligning their financial viability with environmental and social objectives. While striving to transition towards a net-zero economy requires investment in sustainable initiatives, these projects may not always yield immediate financial benefits and might appear risky under the current financial standards.

As a result, PDBs seek innovative financing methods like green bonds, guarantees, and financial innovation to attract private investment and uphold their goals of a global zero-emission economy.

PDBs can play a role in improving the quality of data collection, combining social dimensions with climate vulnerability, and defining specific tracking indicators. They can have a positive and broad influence on governments, the private sector, and communities due to their diverse experiences in addressing various social and climate-related issues worldwide.

Nicole Pinko, a senior analyst at the Climate Policy Initiative (CPI), points out, “there is currently not widely understood or adopted single approach for financial institutions to align their investments or portfolios with the Paris Climate Agreement, although the two main approaches are ‘Paris-aligned Project’ and ‘Net Zero Portfolio’ often used by the public and private sectors.”

By undertaking a thorough review of literature and holding a series of interviews with external experts and public development banks, the Climate Policy Initiative found that each approach has a variety of benefits and weaknesses and how they could be implemented across the wide landscape of public development banks.

A Paris-aligned project approach has a stronger connection to long lasting reductions of emissions of the real economy, while a net-zero portfolio approach allows for a more quantitative measurement. Both face challenges regarding data limitations and assumptions concerning prior emissions.

While the analysis is still ongoing, a hybrid approach (taking the most comprehensive and effective aspects in each one) may be the best way for public development banks to achieve long lasting reductions of emissions in the real economy.

In particular, PDBs in the Latin American and Caribbean region have been working on building greater institutional capacity to understand the physical and transition climate risks and how they affect their operations. They are specifically making progress in identifying relevant climate threats affecting their clients, including geographic and sectoral contexts.

Lauren Biddiscombre, Deputy CEO of Operations at the French Development Agency (AFD) and the Club of Development Banks, commented, “The path to alignment with the Paris Agreement will test our culture, intellect, and will, and we must rise to the challenge.”

Adama Mariko, the FiCS Secretary General, also stated that “we are not coming out of here without having a clear agenda of what public development banks should work on in these five next years. So every session, we’ll be taking note on what people… what are the best ideas they have, what are their targets, what are their objectives, so that we can put that together and show to the world that we can have a plan on which we all work and on which we can be accountable and for the deliverability expected for the SDG’s.”

One key aspect of the potential steps to follow is incorporating climate-related risks into the institution’s risk management strategies. Additionally, once vulnerabilities in the credit portfolio are identified, it is crucial to translate them into financial impacts so that PDBs can incorporate climate-related risks and opportunities into their strategic planning and successfully allocate capital to make investments in climate mitigation and adaptation from both the Paris Agreement and zero-emission perspectives real.

The Amazon, a Prime Example

The Amazon is an early success story in this regard. National and subnational development banks have been addressing significant market failures to promote sustainable development in the Amazon, including gaps in financing, coordination issues, and technical knowledge.

The Green Coalition of Development Banks is the implementation support of the Amazon Forever Program, which aims to tackle two key challenges in the region: the lack of financial resources available for investments and the maturity level of existing project portfolios. The initiative is based on five pillars: combating deforestation, bioeconomy, people, sustainable cities, and sustainable agriculture, livestock, and forestry with low carbon emissions.

By participating in the Green Coalition for Development Banks, national and subnational banks from Amazon-region countries will collaborate to create and implement financial solutions and provide technical support to address these five pillars.

These efforts will consider local and regional characteristics with the goal of facilitating the expansion of companies prioritizing social, environmental, and economic sustainability. These endeavors will promote inclusive and productive enterprises to foster the harmonious growth of the Amazon biome while simultaneously while working towards reducing social and regional disparities.

The Green Coalition will provide financial and technical support to public and private projects that promote sustainable, inclusive, and climate-positive economic alternatives for the region. The Coalition will apply a holistic approach with projects that promote local employment and income opportunities, especially for low-income families.

Adjustments to Models and Adopted Commitments

Public development banks need advanced risk assessment frameworks to capture environmental, social, and financial risks while adapting to changing regulations and policies that could affect project viability and strategy delays.

The speed at which these frameworks are adopted is paramount to the fight against climate change, as are the decisions supporting these policies. According to the results of a self-assessment undertaken by the Financial Markets Division of the IDB, considering 14 Public Development Banks in the region, 64% of these entities have publicly expressed their commitment to national goals in alignment with the Paris Agreement and have taken concrete actions to align their operations.

However, these PDBs still face the challenge of translating climate commitments into specific objectives and targets, both to place climate financing products and reduce carbon intensity in their portfolios.

In terms of risk management, 64% of Local Development Banks (LDBs) have already approved mechanisms for identifying and managing environmental and social risks; in 36% of these entities, this process already includes climate risk.

14% of the participating Local Development Banks in this survey are already evaluating the resilience of their portfolio and defining the alignment of their credit placement policy regarding climate change; an additional 7% plan to do so in the next 12 months.

64% of the entities have approved and current specific criteria for identifying and classifying credit operations or productive projects that contribute to climate change mitigation or adaptation.

However, there is a significant challenge in terms of broad public policy definitions. 71% of BGFs have not yet explored adopting an exclusion policy or a gradual strategy to eliminate the financing of carbon-intensive sectors or economic activities. Only 21% intend to adopt such a policy in the next 12 months, while the remaining 8% state that, for the time being, they will not adopt an exclusion or gradual elimination policy.

In conclusion, this is a work in progress; a change in thought can only come through consensus and the exchange of results-based experiences. As seen, there is much innovation and interest in achieving this in a very short time.