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Private-Public Sustainable Finance

An analysis of the actions and incentives of players in ESG investing

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Executive Summary

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Finance is key in delivering the just transition to a sustainable economy. Equally as critical as public finance is in supporting the just transition, so too is the mobilisation of private finance. The world's banks, insurers and investors must make sustainability a core component of their strategic plans by ensuring that net zero goals are achieved and core labour standards and human rights are applied. In having said this, it is evident amongst economists and governments that climate action requires a significant investment over the next 15 years. According to the IPCC, the annual net zero investments in developed countries must grow three to six-fold by 2030. For developing countries, an investment expansion of four to eight times is required, growing annual green investment from less than $500 billion annually to a potential annual investment of $3 trillion.

The following report will dive into the actions and incentives of the four major players in the private and public sustainable finance field to shed light on both the opportunities and challenges concerning the current state of ESG investing. In Section 1, we first observe how privately owned companies and banks invest in projects promoting positive environmental and social outcomes. This section explores the rise of sustainability reporting and bond issuance from companies and ESG integration by private banks. The main factors of influence across private players are client preferences and regulations at the national and international level. Companies are incentivised to be ESG compliant by fiscal advantages as well as by being more attractive to investors and customers. Similarly, private banks are influenced by a shift in clients' preferences towards impact investing, as well as in Europe by the Sustainable Finance Disclosure Regulation (SFDR) and the EU Action Plan, which require all banks to incorporate sustainable finance as one of the core parts of their operations.

Following this, Section 2 offers analysis of the actions as well as the key reasons found at their core. Public actors' activities in the sustainability space are pushed by an additional set of forces compared to private ones. Political reputation and national and international commitments such as the ones taken at COPs are fundamental for government accountability in ESG-related issues. Instead, public banks are primarily driven by long-term financial stability, as climate change and natural disasters can cause economic turbulence.

Public and private stakeholders have many choices to play a more active role in adopting ESG standards. In the last decade, sustainable financial instruments such as green and social bonds have flourished, new companies' commitment initiatives such as Climate Action 100+ have been developed, and the presence of governments in driving sustainable projects has increased, with their collaboration in development impact bonds and issuing net zero regulations.

However, more needs to be done. A recent survey by the World Benchmarking Alliance concluded that 'the vast majority of high-emitting companies are failing to demonstrate efforts towards a just transition'. At the same time, there is an alarming shortfall of sustainability-linked bonds and loan options in emerging economies.

This report offers a clear picture of what the major stakeholders in the sustainable finance field can do and raises awareness of the incentives that can increase sustainability actions in the finance space.

1. Private Sustainable Finance

1.1. Companies

Akshay Honmane

Companies have become increasingly aware of the importance of integrating sustainability into their business models and investment strategies. This has been further influenced by the growing focus on environmental, social, and governance (ESG) factors in the investment community. Companies are playing an important role in private sustainable finance by investing in projects promoting positive environmental and social outcomes. In this context, the role of reporting standards, resilience financing structures and transnational institutions remain critical.

Actions

ESG reporting and public disclosure have become the cornerstone of the present global private climate governance system. Although presently under its infant stage of development, the financial instruments under ESG offer key solution structures facilitating sustainable investments and embracing untouched market potential. Private sector companies report their ESG performance to disclose their sustainability commitments to investors, customers and employees. Both private and institutional investors value companies based on their ESG reporting while helping regulators to ascertain the obligations on carbon emissions. In this context, ESG frameworks are the pillars of the quantifiable metrics and reporting standards that are set and implemented by companies. Some of the prominent reporting frameworks, such as the Global Reporting Initiative (GRI), International Sustainability Standards Board (ISSB), Climate Disclosure Standards Board (CGSB), Sustainability Accounting Standards Board (SASB), International Integrated Reporting Council (IIRC), and Task Force on Climate Related Financial Disclosures (TCFD) offer comprehensive frameworks based on business requirements. Contrastingly, critical theorists have questioned the legitimacy of voluntary reporting standards due to their "ambiguous" nature. Likewise, others have emphasised that ESG reporting increases the ESG performance of companies only under certain circumstances. For instance, in the case of H&M, when it launched its first sustainability report in 2013, it offered the company positive support from wide stakeholders, consumers and investors. However, in 2018 when H&M faced staunch criticism for falling behind its sustainability commitments, it led to a decline in its stock prices. Therefore, ESG performance also depends on certain circumstances, such as how committed the company is towards its ESG goals. Despite ESG complexities being the critical feature of sustainable accounting, the financial innovation post-Paris Agreement has been instrumental in creating resilience-financing structures for corporates.

There is a two-way process of building resilience financing structures. The first being the supply side led by financial sector innovation such as institutional investors, green bonds, banks, credit unions and through greening existing financial products such as mortgages and insurance. The second part of the process is the demand side, led by capital-intensive projects such as renewable energy, transportation and energy service companies requiring market finance with long-term payout periods. Green bonds have recently become popular due to their potential to raise funds for multiple sectors. The European Investment Bank was the first to issue such a bond in 2007 with the "climate awareness bond", which was later renamed as "green bond" by the World Bank in 2008. Similar to any other bond, green bonds are a fixed income financial instrument to raise funds from investors from debt capital markets. However, unlike typical bonds, there is a commitment to use the capital to finance or refinance 'green' projects. The green bond market is expected to grow between $900 billion and $1 trillion in 2023 compared to $850 billion in 2022, as the asset class is expected to fill the climate financing gap in 2023. According to S&P Global, the bond markets will increase modestly due to a slowing rate increase and persistent inflationary pressures. The predicted expansion of the green bond market therefore showcases the issuers' approach to ESG and their willingness to deliver reputational benefits and sustainable strategy.

Other instruments are led by multilateral organisations such as the Green Climate Fund (GCF); through its Private Sector Facility (PSF), it promotes private sector investment via concessionary low-interest and long-tenor project loans. It is expected that developing countries will require $2 trillion annually to mitigate and adapt to climate change effects. Resilience financing thereby directly benefits companies by reducing their carbon footprint through sustainable investments. On an institutional front, investment initiatives to support small and medium enterprises in achieving sustainable practices have been primarily taken by the European Commission under its European Investment Fund, which several institutional and private investors back. Such strategies not only benefit the market in the short term but are incorporated in the decision-making process of the firms in the long term. According to the BNP survey of 2019, over 50 per cent of investors seek to integrate ESG as a mean to ensure long-term incentives and maintain the reputation of their brand. Companies are increasingly seeking investments in philanthropic activities. For example, Bloomberg invested over 1.66 billion in 2021 globally across 941 cities and 173 countries. Bloomberg's investments are targeted towards developing human capital and improving environmental protection. Such efforts further enhance the public services standards and ensure accountability. For instance, the K-12 education reforms, a $750 million initiative supported by Bloomberg in the US, aims to bridge the collapsing public education system by expanding charter schools. Such reputational benefits received from philanthropic activities further benefit the corporate governance structures on the multilateral and transnational front.

With new reporting standards and the upcoming scope of resilience finance, transnational initiatives specifically led by corporates are essential for steering net-zero commitments. Climate Action 100+ is one such example of a voluntary investor-led initiative comprising 166 companies committed to net-zero transition and enhancing corporate disclosures. Climate Action 100+ provides the required secretariat support, technical assistance, as well as helps create new opportunities for effective engagement through skill enhancement. It has further brought together over 370 investors with $38 trillion worth of assets under management. The focus companies are estimated to contribute to over two-thirds of the total industrial GHG emissions. It also leads to a greater focus on the "G" in ESG, i.e. good corporate governance enabled through effective leadership and shareholders' cooperation.

In this context, Climate Action 100+ had recently invited public consultations on the net-zero company benchmark for its next phase of emission reduction goals. However, despite its ambitious pledges towards comprehensive long, medium and short-term targets, Climate Action 100+ is far from achieving the targeted outcomes. Less than 12 per cent of the initiative's companies have published their decarbonisation strategies. Furthermore, oil and gas companies increasingly invest their capital in projects inconsistent with the Paris Agreement target of 1.5°C. Therefore, in practice, there are several inconsistencies that require cooperative solutions on the ESG side, and interest from companies to align with stakeholder values has created an almost social stigma around not having ESG-focused growth. Nevertheless, through such initiatives, private actors have more significant incentives to steer voluntary commitments to reduce GHG emissions. Firms involved in transnational initiatives reap reputational benefits, technology transfer, and knowledge sharing, thereby increasing their market value.

Incentives

Ottoline Mary

ESG integration can help companies to improve their financial performance. Although there is no guarantee, there are a few factors to reflect upon. Firstly, the increase in regulatory responses to emissions and climate-related bans and limitations will make certain assets less profitable. According to *McKinsey*, committing to ESG can help companies allocate capital to sustainable opportunities, thereby leading to investment and asset optimisation (e.g., by "avoid[ing] stranded investments that may not pay off because of longer-term environmental issues"). Moreover, as noted in *Deloitte Insights*, the sustainability imperative introduces new constraints to the resources involved in production and consumption, thereby encouraging innovation. Innovation, in turn, helps a company build competitive advantage, which can improve financial performance. Secondly, ESG integration entails a holistic approach to risk in all its aspects: internal as well as external, environmental as well as social, long-term as well as short-term, etc. Hence, committing to ESG tends to improve companies' overall risk management, thereby driving better financial performance. In this context, AIIB suggests that ESG investing might constitute a "safe haven" amid crises such as COVID-19. The resilience of ESG-focused assets in both developed and emerging markets may be explained by the long-term outlook they support.

As a counterpart to the heightened taxes imposed upon actors who do not fulfil sustainability requirements, governments are dedicating an increasing number of tax incentives, soft loans, and cash grants to companies that commit to making environmentally and socially responsible investments. The EU offers the blending funding: a combination of tax benefits, cash grants, guarantees and loans for companies requiring capital and investments to support their growth. Currently, the majority of European countries offer R&D tax credits for companies investing in R&D within sectors such as tech, pharma, food processing and financial services. Apart from the West, African countries of the Global South offer energy-efficiency incentives that help companies to claim tax deductions. In Tunisia, companies reducing their electricity and water consumption are provided with an additional 50 per cent incentive for investing in renewable energy projects. In this context, on a global scale, PwC has designed an interactive Green Taxes and Incentives Tracker providing up-to-date accounts of ESG-related fiscal advantages available in selected countries.

Studies have highlighted that a high ESG rating could make a company more attractive to investors. The Kenan Institute observed that an increasing number of investors are willing to buy stocks from companies with high ESG ratings at a premium, thereby heightening returns for the latter - at least in the short term. Conversely, investors are incited to avoid companies with low ESG ratings, perceived as riskier overall - since they may imply damage to the environment, unfair labour practices, corrupted governance, etc. Deloitte suggests that 65 per cent of investors use ESG assessments on a regular basis, and it was estimated in 2020 that approximately a quarter of the assets under management in the US were investments in high ESG-rated companies.

Similarly, a low ESG rating could make a company less attractive to socially conscious employees. Like investors, prospective employees tend to be deterred by poor social licence. A study conducted in the UK in 2021 by Opinium Research Ltd found that between 53 per cent and 59 per cent of candidates would refuse to work for an unethical employer regardless of the salary and that 30 per cent would leave their job if their employer was unable to raise its ESG rating. Similarly, in another study by DWF, 40 per cent of companies stated that they had trouble recruiting key talent due to their ESG policies being perceived as weak.

1.2. Private Banks

Anders Chung

Compared with other key actors, private banks are demand-driven and micro-focus on delivering ESG initiatives, performing as an anchor between investors and regulators that facilitate ESG implementation. As ESG brought a new wealth management trend that encourages investors to rethink their investment strategy by incorporating non-financial factors, private banks provided services on the transition regarding ESG integration, assisting clients in analysing ESG information on investment opportunities, assessing potential impact, and taking sustainability considerations into decision-making. With a target to improve clients' ESG performance and profile outlook, private banks also ensured the quality of clients' ESG investment preventing Greenwashing.

Private banks also underwent the transition to be compatible with ESG within their organisations, which are incentivised by a combination of internal and external factors. The external factors include the potential return and bright prospects in the ESG market, clients' demand and the changing investor's appetite. In addition, Regulations have also been a strong motivator for private banks to expand their ESG-related services and investment products. The internal factors include coping with internal sustainability goals, increasing resilience to regulations, and increasing social credibility.

Actions

As service providers, private banks play an increasingly influential role in ESG implementation by providing different ESG solutions to their clients, helping them achieve ESG goals or comply with the rapid-evolving regulations. The emergence of ESG investing delivered a new norm of wealth management, where investors are encouraged to consider non-financial factors as part of their analysis process to identify material risks and growth opportunities.

Subject to the growing demand, helping clients with ESG integration became an essential service of private banks. The UN Principles for Responsible Investment (PRI) define ESG integration as "the explicit and systematic inclusion of ESG issues in investment analysis and investment decisions". In other words, it puts ESG considerations on the same level as other material financial factors when making investment decisions. In practice, private banks assist clients in analysing ESG information of investment opportunities by identifying ESG factors, assessing their potential impact, and incorporating sustainability considerations into decision-making for investment. Moreover, it is worth noting that private banks also assist their clients in improving their ESG profile and ESG reporting to enhance the organisation's reputation, meet the regulatory requirements and achieve their organisation's sustainability key performance indicators (KPIs). While the demand and revenue from ESG grew, private banks demonstrated noticeable improvements in providing ESG integration to clients in recent years. Aside from relying on ESG ratings from market data providers, private banks have upgraded their services by deploying specialists and in-house ESG analysts, applying proprietary data and security modelling in ESG-related assessment.

A major function of ESG integration is to mitigate risk. ESG risk management addresses a variety of criteria that go beyond conventional business and financial risks. According to the EU's Sustainable Finance Disclosure Regulation (SFDR) introduced in 2019, sustainable risk refers to “an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.” Taking ESG factors into account enriches the risk management framework of an organisation. In a sense, it strengthens an organisation’s business model with more adaptability to issues in a globalised world such as climate change, supply chain instability, geopolitical turbulence and unprecedented crises. COVID-19 perfectly exemplifies why ESG is so important to business management nowadays. In the first quarter of 2020, stocks with strong ESG ratings outperformed others amid the stock market slump. It proved that an organisation has more resilience to risk when bringing in ESG factors in management.

Apart from ESG integration, private banks also act as providers of ESG investment products. In the last few years, private banks have significantly increased their sustainability investment offering. A report published by PwC studied the sustainable investing capabilities of 20 private banks and discovered that the average number of sustainability investment offerings received a significant growth annually of over 200 per cent from 2019 to 2021, covering a vast range of products such as Green bonds, Green ETFs, ESG warrants and sustainable investment commodities, for instance, sustainable gold. In terms of Assets under Management (AuM) in sustainable investing, it resulted in a consecutive surge globally from 30.7 trillion in 2018 to $35.3 trillion in 2020 and has grown by 15 per cent in two years, according to the Global Sustainable Investment Alliance (GSIA). With a wide range of ESG investment tools, private banks enjoy great flexibility to offer tailor-made investment strategies to clients. A categorisation of GSIA is widely adopted by the industry, which classified sustainable investing approaches into seven non-mutually exclusive categories: exclusion, norms-based screening, best-in-class, ESG integration, active ownership, thematic, and impact investing. Taking clients’ preferences on ESG commitment, risk acceptance and specific themes into consideration, private banks can translate the needs of clients into relevant investment products.

Incentives

The motivation of private banks to increase participation in ESG is demand-driven, consisting of a combination of internal and external factors. Not surprisingly, the demand from the market and the financial returns of ESG are predominant external factors for private banks (in practising ESG). The ESG market is fast growing and uneven across different regions of the world, which means there is substantial undeveloped potential in ESG investing in latecomer regions, particularly Asia and the MENA region. Research published by consultancy Alvarez & Marsal indicated that the global annual revenue pool for banks related to environmental, social and governance products and services will reach €295 billion, or $300 billion, by 2023. The huge demand and bright prospects are undoubtedly the main drivers for private banks to devote to ESG. The influences of end-investors should not be downplayed. OECD's research claims that although the majority of institutional investors focus on the financial return of ESG investing, end-investors focus more on whether a company's ESG portfolio is aligned with societal values. The value focus of end investors would be an incentive for private banks to provide more impact-oriented products and be more cautious about green-washing.

Private banks are also driven by a shift of client preference: from focusing only on profits to increasingly integrating the sustainability aspect into business decisions. There are more organisations incorporating climate change or the UN Sustainable Development Goals into their corporate values. In fact, McKinsey Quarterly found that paying attention to ESG concerns does not necessarily compromise returns. Instead, it facilitates value creation. Apart from revenue growth, companies also get benefits from cost cutting, resilience to regulations, boost employee motivation, as well as increasing their social credibility. Therefore, instead of just reacting to government regulations, companies have sufficient motivation to make more effort on ESG factors. Hence, private banks respond by increasing ESG-related services and investment products.

Regulations have traditionally been a strong external pressure on private banks to improve their sustainable investing solutions. In Europe, the SFDR and the EU Action Plan are powerful driving forces demanding all banks incorporate Sustainable finance as one of the core parts of their operations. Also, guidelines from the Task Force on Climate-related Financial Disclosures (TCFD), Sustainability Accounting Standards Board (SASB) and The International Sustainability Standards Board (ISSB) are getting more standardised with clarity. Investors are allowed to have a more organised framework to access an institution's sustainability performances. In contrast, private banks have to comply with these frameworks and accelerate services to help clients, or themselves in building up ESG portfolios.

Lastly, most banks are setting up sustainability goals for themselves due to the growing public awareness of ESG issues. From the angle of private banks, the incentive of setting up internal sustainability goals might vary, for instance, to present a responsible corporate outlook to the public, to comply with regulatory demands, or to echo stakeholders' concerns to contribute to a sustainable future. Despite what their true intention is, the sustainable goal of banks is a key internal incentive for them to participate in ESG practices. In general, private banks would set up KPI committed to different ESG concerns, for instance, cutting financed emissions or raising sustainable finance targets. Also, for public tracking and transparency, many private banks publish their sustainability reports and review their KPIs regularly.

2. Public Sustainable Finance

2.1. Governments

Rosie Inwald

Alongside private actor salience in promoting ESG investments, governments are also instrumental in incentivising and engaging interest in sustainable finance. On regional, local, and national levels, governments have proven to be central to providing structures and circumstances in which the shifting focus towards more ethical investing is able to thrive. From PRI's 'A Legal Framework for Impact,' the report concluded that where actions taken by jurisdictions are successful and achieve investors' financial goals, the investor is likely to consider using more sustainable frameworks and act accordingly. Since the Paris Agreement of 2015, governmental and intra-governmental institutions have established various sustainable finance initiatives, from mandatory or voluntary ESG reporting to policy favouring impact investing instruments. The past few years have shown a global pique in interest surrounding sustainable investing, resulting in pressure on local and national governments to respond with heightened regulations and legislation.

Actions

Impact investing instruments are a central feature of government action aiding the redirection of economies towards more sustainable futures. Here, governments play a role in favouring such instruments, acting either as insurance in supporting such programmes or creating them in the first place. The possibilities of these actions include simple government funding of environmentally positive programs and 'Payment for Success' instruments in which an outcome funder pays to achieve an agreed outcome. Also referred to as Development Impact Bonds (DIB), this remains a component of both public and private action together. Within a government context, innovations in impact investing have included the emergence of the Social Impact Bond, seen in the UK first in 2010, referring to the contract between a special purpose vehicle and government in which the government commits to pay for an improved social outcome, addressing social issues through investments.

Additionally, 'carrot and stick' approaches are fundamental to incentivising engagement with ESG-focused investing, shown by actions such as taxing environmentally harmful activities and requiring certification for energy performance. Federally, Canada is an interesting example of this. A 2022 report notes that Canada's federal carbon tax is expected to increase petrol prices by around 8 per cent, coal prices by 100 per cent, and natural gas by 50 per cent over the next four years. On a global scale, we have seen these actions taken by examples such as Germany committing €2.5 billion to investments in EV infrastructure and Shenzhen, China incentivising three major bus operators to transition to EV vis-à-vis annual subsidies of USD 75,500 for a single vehicle.

Taxonomies must be harmonised across countries for sustainability-oriented financial instruments to ensure the effectiveness of impact investing structures. In establishing climate finance taxonomies and other classifications, investments can be aligned with global climate goals, as well as those at the local level. Though such ambitions are difficult to attain, with differing local and regional interests, participant agreement on global guiding principles marks an active step towards government-enforced sustainable investment. The EU's 2021 Taxonomy Regulation designed to support the shifting EU economy towards alignment with the 'Green New Deal' constitutes an example of such actions. Publishing this more recent classification tool seeks to ensure clarity for companies, policymakers, and capital markets, guiding these individual actors towards more sustainable economic activities. The six environmental regulations are of interest here, looking at climate change mitigation and adaptation, sustainable use and protection of marine resources, transitions to a circular economy, pollution control, and conservation of biodiversity and ecosystems. The harmonisation of taxonomies and ESG-focused classifications must, however, be reinforced through government policy on disclosure. Amendments to the EU's Non-Financial Reporting Directive and the Sustainable Finance Disclosure Regulation are only two examples in which disclosing information holds individual actors accountable, aligning their activities with the Taxonomy.

Under the EU's Action Plan on Sustainable Finance, the legal basis for classification systems are outlined, ensuring a common set of principles are in line with the supranational commitments to ESG. Not only do classifications need to be harmonised on global levels, but also from the federal to the local. Looking at President Biden's 2021 Executive Order No.14030, Biden called for a "comprehensive, government-wide strategy" on climate financial risk. Ensuring that action is effective, these policies need detailed planning, unlike the failure of the UK Green Homes scheme in which design and implementation was criticised as rushed. To this end, an uneven regulatory landscape undermines the possibility of effective governmental ESG-related action.

Incentives

Whilst government action is important to consider, the incentives for action to be taken are also of interest. Notably, the political salience of ESG issues indicates that further government action is required. Over the past few years, both private and public sectors have shown an increased awareness of ESG-related issues driven by the demands of various stakeholders, including the public, consumers, and non-governmental organisations. The impact of the Russia-Ukraine war has undoubtedly disrupted global energy supplies, creating a paradoxical force making the issue of green energy transition more pressing, yet more challenging. In response to this issue, countries are pledging to reduce dependency on Russian oil and gas, as seen with Germany. Agreeing to a package of reforms in July, the German government aims to increase renewable power production, expecting to end purchases of Russian coal and oil later this year and of natural gas by 2024.

Another incentive for governmental involvement to encourage ESG-focused investments pertains to the simple measure of avoiding massive long-term costs and attracting investment. Increasingly, a large portion of global investors are utilising ESG factors as a deciding factor in where money is placed. The extent to which governments and jurisdictions act and are positioned in support of strong ESG disclosure and performance can boost investment and procurement competitiveness. Other reports have also found that jurisdictions associating themselves with ESG-focused strategies enables greater attention and attraction of FDI to the jurisdiction itself. The past few years have seen major investment and credit rating research agencies applying ESG factors to risk assessments of governments at all levels. Such agencies include Moody's, Fitch, and MCSI, whose ratings influence government credit rating and the ease with which financing and borrowing costs are secured. In recording factors such as GHG emissions, air quality, human rights and political freedoms, Fitch Ratings expose government actions on a visible and accessible scale. Notably, a study of 20 OECD countries concluded that jurisdictions with a 10 per cent higher ESG score reduced the sovereign bond spread by 11 per cent in the short term, increasing to 16 per cent in the long-term. To this end, McKinsey & Co. have also reported that the ESG links to cash flow are an incentive for government action in five ways: facilitating top-line growth, reduction of costs, minimising legal and regulatory intervention, increasing productivity, and optimising investment. Alongside an emerging trend of government credibility held to account by external actors, experts have noted the impact of climate change as a crucial factor in long-term financial returns. From IGCC, government incentive is tied to the immediate threat of environmental decay.

Incentives for government investments in ESG-related issues also pertain to respecting national and international commitments. In tandem with the UN's Sustainable Development Goals, the Paris Agreement, and the recent COP27 Sharm el-Sheikh Implementation Plan (SHIP), agreements on climate action hold governments accountable to these commitments on a global stage. Returning to a focus on the European Green Deal, the European Commission, on behalf of member states, committed to a growth strategy intended to make Europe the first climate-neutral continent by 2050. A further incentive provided by this supranational organisation was that of the accompanying investment plan mobilising at least €1 trillion of sustainable investments over the coming decade. Here, we see the incentive established through international organisations constructing an enabling framework by which ESG-focused action can occur, with financial benefit received from acting upon these commitments as salient.

Specifically, the COP agreements require a collective approach which is primarily sustained through the long-term commitment of governments.

Yet, a limitation of government incentive to act on ESG issues and, more widely, public sustainable finance, is that of the collective action dilemma. Globally, the COVID-19 recovery process has placed significant strain on public finances whilst also highlighting countries' general lack of action to work collaboratively in the face of crisis and necessary change. Collective action is thus more convincing in apt conditions, a point helped by better planning and implementation of ESG policy practices. For example, we can extend this conversation to Chinese policy on ESG disclosure, differing from the EU and US frameworks. As of 2022, compliance with government ESG regulations remains voluntary. Though central-level authorities have issued mandatory guidance on working conditions and overtime following public outrage on social media, guidance from CERDs emphasises compliance with Chinese security law, leaving ESG reporting in disharmony with the other regions. As mentioned previously, the harmony of taxonomies and classifications is one action governments can take to institutionalise sustainable finance. This disjunction of collective action is thus a limitation on the incentive for ESG cooperation. On top of this, local politics must be considered within the context of effective government incentives for ESG investments. Within the United States, the politicisation of ESG issues over the past few years is proving difficult to gauge due to its emergence as a political flashpoint reflecting partisan differences. Taking from former Vice President Mike Pence's op-ed in May 2022, he claimed that the promotion of ESG resides with activists rather than shareholders, indicating a move to discredit ESG investments. This also introduces the issue of political short-termism. Thus, a challenge to this process is that with sustainable and ESG-related investments reaping benefits over a long-term period, governments are subject to change during this process. Thus, in addition to the politicisation of ESG issues in the US, we see that changes in governing parties act as another factor incentivising the implementation of public sustainable finance.

2.2. Public Banks

Ares Edvart Zerunyan

The increased focus on ESG over the past few years has changed the aims of public banking institutions. Observing public banking policies is important due to their relationship with the state. State banks play an essential role in adopting ESG in the coming years, as they tend to make more long-term investments that do not always provide short-term returns. Sustainable and green financing are often investments of this ilk. Many public bank reports focus on the transitional phase after adopting greener policies. Public banks are eager to alleviate stakeholders' worries in the build-up towards completely sustainable investment. Now that the focus has shifted to ESG, public banks are offering risk management services and guidance on how to comply with new regulations on green policy. This section will look at some of the steps that are being taken by public banks while also looking at what kind of incentives exist for public banks in the world of ESG.

Actions

Public banks have many choices regarding taking a more active role in adopting ESG standards, which range from conserving electricity or emissions to investment in clean energy sources. Regarding direct environmental benefits, banks can target initiatives focusing on deforestation or creating more sustainable water management. Actions can also branch out into more social projects or focus on health. Public banks have become increasingly aware of ESG. However, until now, they have struggled to take significant action. Throughout the public and private sectors, there is a fear over the lack of information on the risks of transitioning to a world with green policy and net-zero emissions. One of the justifications for taking more action is that by doing so, financial regulators in public institutions would be able to gain a better idea of the risks and therefore produce a more accurate assessment of risk. An important aspect to consider is that for many central banks, getting a return on investment is not the aim of their portfolios. Moreover, the increase in potential investment options for central banks via quantitative easing could pave the way for more significant investment and consideration into ESG.

Banco Central do Brasil has stepped up its ESG regulatory framework models. It has compiled a list of risks banks must incorporate into credit models. Banks will be expected to devise ways to anticipate mitigation and responses to compensate for losses from environmental fines, land contamination, natural disasters or overuse of sources. In September 2021, the Central Bank of Brazil published new rules regulating ESG products and climate risks.

The new framework includes legal and intralegal limitations on social, environmental and climate issues, particularly in rural credit contracts. Related analysis and risk management procedures for financial institutions, how sustainability affects rural credit dynamics and mandatory disclosure requirements. Brazil has only started to issue green bonds recently, and there is still much progress to be made. Banks are trying to reduce carbon emissions and create organisations while pushing for transparency.

The Bank of Canada made its commitment to climate change for COP26. Citing the increasing rate of natural disasters and the physical risks from harsh weather conditions and its harm towards the financial system that by proxy would damage labour productivity, agricultural yields and industrial output, the Bank of Canada committed to specific changes. The Bank of Canada piloted a climate transition scenario analysis project with the Office of the Superintendent of Financial Institutions. The project aimed to grasp how the financial sector was susceptible to risk when switching to a low-carbon economy. Thus, they drafted some transition scenarios to project different risk outcomes that could challenge the Canadian economy. These are the results of the project. The BoC is taking on a more global approach, a plan it will conduct with the Network for Greening the Financial System, the IMF and the Financial Stability Board. The BoC has reported some very tangible results so far. They aim to reduce greenhouse gases from buildings by 80 per cent by 2030. By 2050 they're aiming for zero emissions. In addition, they want to commit the totality of their electricity needs to renewable sources in 2022. In addition to this, they renovated their headquarters with a sustainability plan. 90 per cent of construction was diverted from landfills, for example. Electricity use in the head office was reduced by 50 per cent, equivalent to moving 1300 homes off the electricity grid. They've taken steps to add their water and waste footprints too. They are currently using their task force on climate-related financial disclosures. ESG principles are also mainly used in the Bank of Canada Pension Plan.

The Bank of England has increasingly focused on taking climate change into account. To this end, they are focusing on transitioning to net-zero emissions, in policy functions and operations, just like the banks mentioned above. They have attempted to wind down stock holdings that would compromise green values or greening plans. The Bank of England has outlined its strategy for tackling climate change, particularly insisting on its ambition to take a leading role. It strives to create an environment where the financial system, macro-economy and bank are not vulnerable to risks posed by climate change and preparing for the transition to net zero.

Another British public institution, NatWest, has provided a breakdown of how it offers sustainable finance options to its clients. NatWest offers frameworks for financial institutions for Green, Social, and Sustainability financing. This includes developing and assessing KPIs for transactions such as loans or FX and providing ESG ratings and disclosures. Natwest offers advisory on Sustainability focused bonds, loans, securitisation and capital products, bespoke sustainability-focused risk solutions, ESG investor engagement, policy/regulatory development and carbon markets. There is also support for corporations; NatWest has started offering extensive ESG Financing and Risk Management services. Risk management services include Sustainability labelled debt and loans, green supply chain finance, Green and ESG-linked commercial paper, ESG deposits and derivatives, non-deal roadshow, and investor engagement. ESG advisory services include ESG rating support, strategies for investors, reporting and disclosure, and guidance on regulatory and other market developments. They also provide a short-term product framework for their clients. One of the features is their activity in carbon markets, where they have offered companies or governments the opportunity to buy carbon credits to reduce their emissions. In 2021 NatWest took the step to help the NWM Group in establishing Carbonplace, which is a digital exchange platform for trading high-quality carbon credits in conjunction with the Taskforce for Scaling Voluntary Carbon Markets. Finally, in the public sector, NatWest has been involved in projects such as the Accelerator Cities Programme of the UK Green Building Council. Things bring together people from the major cities in the UK and other stakeholders to develop a playbook for the project.

La Banque Postale (LBP), in 2020, has pivoted towards environmental, societal, territorial and digital considerations, with 100 per cent of funds labelled Socially Responsible Investment (SRI) at the bank. In other words, 22 billion EUR have been invested in transition energy. The bank has promised to differentiate its investments by establishing partnerships focusing on international development in Europe and South America. CSR (Corporate Social Responsibility) has been at the forefront of the LBP approach, particularly when it comes to two factors, inclusion and sustainable finance. The bank has made significant commitments. Achievement of the inclusivity dimension has been helping 1.5 million customers benefit from accessible banking, while the bank has supported 1.4 million financially vulnerable customers.

Regarding sustainable finance, 106 SRI funds belonging to LBP AM have gained the SRI label. At the same time, 1 billion EUR in green loans were handed out to finance projects that will positively affect the environment. LBP AM has committed to a 100 per cent SRI strategy, meaning 100 per cent of its open-ended funds for the French public are approved. In other words, 111 funds for 257 billion, and 63 per cent of its assets are being directed towards responsible investments.

The Belgian Investment Company for Developing Countries (BIO) has based its approach on the UN sustainable development goals. Its report has outlined its desire to act on the many crises still impacting the world, such as Covid-19 or climate change.

Public banks have only started to take more of an active role in the world of ESG recently, and there is still much for banks to do. For the time being, most banks are preoccupied with preparing for the transition to a greener future with the right kinds of investments. Public banks can certainly play a crucial role in achieving the goal of a greener future and have the potential to create incentives to encourage the private sector to follow suit.

Incentives

The most obvious incentive for any public bank to take on ESG standards is the question of long-term financial stability. The longer public banks choose not to engage in ESG practices, the greater the cost as the threat of global warming persists. In 2020, one report shared between the SOAS Centre for Sustainable Finance, the Asian Development Bank, the World Wide Fund for Nature Singapore and Four Twenty Seven suggested that by 2030 it would be necessary to spend USD 90 trillion to mitigate climate-related risks. It would not be difficult to imagine that further deterioration of the environment could entail additional costs. Public Banks are primarily focused on integrating sustainable finance into their future operations. There have been fewer publications concerning the other two elements of ESG, i.e. Social and Governance. Still, a multi-faceted approach, as mentioned above, can potentially mitigate many costs in the future.

Government regulations offer potential opportunities for public banks to engage in ESG. For example, the European Parliament (EP) has played a significant role in encouraging the European Central Bank (ECB) to participate in green initiatives. The EP maintains the ECB's accountability, particularly when it comes to adopting the objectives and resolutions of the Paris Climate Agreement, through which the ECB must try to develop a less carbon-intensive portfolio. A research document published by the EP discusses how the ECB should also take greater leadership in enforcing ESG in the private sector. Operational frameworks, credit operations and collateral frameworks, and asset purchases are three areas where change is needed. Moreover, the ECB could lend more to greener companies and raise interest rates when lending to firms in carbon-heavy sectors.

The Paris Climate Agreement provides major incentives for public banks to partake in green policies. Green infrastructure is one area that needs significant investment. According to a Green Investment Opportunity report provided by the Asian Development Bank (ADB), USD 100 trillion worth of investment is required to meet Paris Agreement emission reduction goals. Furthermore, the ADB states that about USD 1.7 trillion is needed to support the creation of climate resilient infrastructure in Asia. The Members of the Association for Southeast Asian Nations called for $120 billion in funding per year, yet over $100 billion worth of funding is still needed to meet the necessary goals. By adopting a more ESG-centric approach to policy, central banks can support governments in achieving their goals of reducing emissions and increasing investment in green projects. The same article states that there are five areas that could be targeted such as sustainable urban transport, clean energy transition, circular economy, agriculture, and oceans. The ADB suggested it could create 30 million direct jobs in Southeast Asia by 2030 if these projects were implemented.

The OECD asserts that public climate finance could become the decisive factor in mobilising private investors, especially in developing countries. One suggestion the OECD provides is creating green investment banks (GIBs) that could specifically target the gaps in green finance. The OECD suggests that GIBs could utilise innovative transaction structures, risk-reduction and transaction-enabling techniques, as well as local and market expertise. The investment can be put towards urban projects, such as residential energy retrofitting (solar energy) or energy-saving street lighting projects. The benefit of GIBs is that they can address ESG issues depending on the needs of the community.

Anouj Mehta, at the ADB, provided a list of ways in which public banks could accelerate the promotion of green policies. Particularly in terms of financing gaps, there is a need for transitioning to bankability, accessing private capital and scaling up models across sectors. Another dimension promoted by the EP report is how public banks have the opportunity to take the lead in prudential regulation. This term describes how central banks serve as risk managers and supervisors in the financial system. Institutions which can perform prudential regulation are needed, particularly for macroprudential or micro-prudential regulation, which deals with policy decisions for the whole state versus financial institutes. On the policy side, central banks could avoid other dilemmas caused by climate change, such as the risk to the stability of food and energy prices. Employment and agriculture, and the extraction of natural resources could also be at risk. The supply-side shocks could force banks to choose between stabilising inflation or any of the factors mentioned above as a result of climate change.

The recent concerns over greenwashing and implementing ‘double materiality’ calls for a body of organisations or institutions to enforce net-zero goals and green finance policies. Central banks could play a crucial role in this type of prudential regulation. Studies have shown that investors are more willing to invest in companies' assets if they disclose their participation in climate risks.

Conclusion

Yann Guillaume

As this report has shown, public and private sustainable finance are two major interdependent forces whose contributions will be instrumental to achieving net zero objectives while respecting evolving societal demands on social and governance standards. ESG has effectively become one of the core components of businesses' short- and long-term strategies. In recent years, the number of companies reporting their ESG performances has grown exponentially, and ESG reporting frameworks have become increasingly more comprehensive. Furthermore, more and more corporations commit to philanthropic investments with explicit ESG objectives. Those trends demonstrate a clear shift in business practices, as companies are more eager than ever to engage in sustainable activities and generate positive externalities for their communities.

This development partially results from the numerous benefits associated with achieving a greater ESG performance. According to various studies, the latter improves financial performance, can lead to fiscal benefits, and increases firms' attractivity to potential employees and investors. This more careful consideration of ESG factors in investors' decisions has been fuelled by a growing focus on aligning their portfolios with evolving societal values as well as by the more rational realisation that a high ESG performance is associated with the aforementioned benefits.

Due to this increased importance of ESG issues to companies and investors, private banks have been expected to play a more significant role in ESG implementation as service providers. They have met this expectation by offering key advisory services to their clients while providing an increasingly more diverse set of ESG investment products, including Green bonds, ESG warrants, Green ETFs and sustainable investment commodities. This wide range of ESG solutions has allowed private banks to become a major stakeholder in sustainable finance, as their services have become essential to facilitate ESG integration.

Alongside this private sector involvement, the role of government has also been crucial in spurring the expansion of the ESG market. Pushed notably by the political salience of ESG issues and the short- and long-term benefits of achieving a sustainable and inclusive economic growth, national governments have provided various structures incentivising a shift to more sustainable practices, including impact investing instruments such as the Social Impact Bond. The evolution of national taxonomies has also largely incentivised taking ESG issues into greater consideration as numerous countries now tax environmentally harmful activities and reward sustainable practices with tax benefits.

In many cases, introducing such measures has also simply been a way for governments to respect their commitments as part of multilateral environmental agreements. Although much progress has been made thanks to those treaties, international collective action problems still disincentivise more government initiatives on sustainability issues, especially as the shortness of electoral horizons makes it irrational for policymakers to focus on such long-term policy problems.

Public banks could partially fill the void created by this dysfunctional incentive structure, as they can afford to have a more long-term vision since getting a return on investment is not the aim of their portfolio. State banks tend to make long-term investments that do not always yield short-term returns. Recently, they have started including ESG considerations in their investment decisions, and most of them plan to integrate sustainable finance even more in their future operations.

Beyond those initiatives, public banks possess the potential to take even more significant action to incentivise sustainable investing and pave the way toward a greener future, e.g. by taking the lead in prudential regulation as suggested by the European Parliament. Arguably, they may be forced into taking this more proactive role because of the growing multi-level awareness that climate change constitutes a major threat to long-term financial stability.

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