CLIMATE BRIEF N°72

The limitations of voluntary climate commitments from private financial actors

Private finance will not fund the transition without a stronger commitment from public authorities

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EXECUTIVE SUMMARY

- **For several years, and particularly since COP 26, considerable time and attention has been dedicated to the subject of voluntary commitments from private financial actors. These commitments, made within the framework of international initiatives, should in principle enable private finance to be mobilized for the transition to a carbon neutral economy.**
- **Such initiatives, however, encounter powerful structural obstacles that limit their effectiveness. While beneficial and worthy of encouragement, we cannot expect these initiatives to deliver more than they are realistically capable of achieving. Indeed, while they can accompany actors from the real economy that are already engaged in economic transformation, they are incapable of making a more decisive contribution to the transition.**
- **This observation leads us to call for a stronger commitment from public authorities. Such a commitment, just like that of other economic agents, will be essential to mobilize private finance to support a rapid and organized transition.**

According to Mark Carney's statements[1] at COP 26, the Glasgow Financial Alliance for Net Zero – GFANZ, an unprecedented voluntary coalition of 500 financial actors with $130 trillion in assets – was destined to be a game-changer in financing the transition to a carbon neutral economy.

But can we rely primarily on this voluntary approach? The answer presented in this Climate Brief is no. Although useful and led by people who are truly committed to the cause, we cannot expect too much from these initiatives to mobilize private financial actors in favour of the given the intrinsic limitations to their effectiveness. Conversely, an approach based primarily on the strong commitment of public authorities seems essential.

This public commitment must be based on a wide range of instruments, including financial regulation, whose role is essential when it comes to financial actors.

The first section of this document analyses what we can realistically expect from financial actors in terms of funding the transition. The second section presents the reasons why voluntary private initiatives cannot play a decisive role, despite the impressive volume of assets managed by the actors who have made these commitments. The third section returns to the decisive role of public authorities in mobilizing private finance.

1 "The core message today is that the money is there, the money is there for the transition, and it's not blah blah blah" United Nations UN News, 3 November 2021.

1. WHAT CAN WE EXPECT FROM PRIVATE FINANCIAL ACTORS IN THE TRANSITION?

Before considering what can be expected from the voluntary initiatives of private actors, it is necessary to clarify the role of private financial actors in funding the transition.

1.1. What is meant by mobilizing private financial actors to fund the transition?

This indirectly raises the question of the role of finance in the economy. A vision based on the total neutrality of finance – which would be limited to financing the needs expressed by economic agents – does not correspond to the real world. The reality is more complex. Financial actors must of course accompany and satisfy the demands expressed by economic agents. But financial actors, certain ones in particular (see below), also play a proactive role in guiding the economy. This is particularly the case when they select sustainable activities or companies in transition to be financed with regard to the risks and opportunities that they present based on their assessment of the prospects for the development of the economy (potential of a technological innovation, possibility of a structural change in a market, etc.).

Regarding the transition in particular, it is vital that financial actors support the call for funding expressed by certain virtuous companies seeking to decarbonize activities or develop climate solutions. But they must also encourage other companies to rapidly initiate the transition of activities that can be decarbonized, or to reduce or even cease activities that cannot be sufficiently decarbonized. Financial actors must be motivated to take such action not only through a commitment to the climate cause or for philanthropic reasons, but first and foremost they must see it as acting in their own long-term interest.[2] Such steps are essential to limit their own climate change risks – including the risk of legal liability – and to increase their opportunities for future profitability.

TO FINANCE THE TRANSITION, ACTORS MUST:

CEASE THE FINANCING OF CERTAIN EMITTING ACTIVITIES

FINANCE "SUSTAINABLE" ACTIVITIES

FINANCE THE DECARBONIZATION OF THE ECONOMY

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To "finance" the transition to a carbon-neutral economy, financial actors must carry out – at the analytical level – three different roles:[3]

- Cease the financing of high-emission activities that cannot be decarbonized (coal, gas, oil, internal combustion engines, plastics industry, etc.)[4] and manage the phase-out of these activities (including identifying and financing the closure of stranded assets);
- Finance, to enable or facilitate, activities that are already "sustainable" (*e.g.* renewable energy) or the development of "climate solutions" (*e.g.* . infrastructure for electric transport or low-carbon hydrogen);
- Finance, to enable or facilitate, the decarbonization of companies operating in the most emitting economic sectors (agriculture, cement, steel, cars, etc.), the energy renovation of buildings (housing, service industry, etc.), and also all other economic sectors that will be indirectly affected by the transition (tourism, health, etc.).[5]

Financing the transition is therefore not only about additional financing for "climate solutions" (which often translates into the idea of a niche dedicated to "green finance"). In fact, it relates to almost all of the finance that must be redirected or adapted to fulfil the three roles identified above.

This financing will have to be provided by both public and private actors. Public finance (not only direct budgetary funding but also via public investment banks, development banks, state holdings, public agencies, etc.) has a key role to play: it is best placed to finance projects that are too risky, and to provide "patient" finance for projects that are long term or less profitable than the returns demanded by financial markets.[6] In emerging and developing economies, the role of public finance is even more important, due to the higher

2 Although this may mean giving up higher financial returns in the short term.

3 Although in practice these roles may partly overlap.

4 According to the analyses of both the IPCC and the IAE, coal production will have to be completely phased out, while residual oil and natural gas production will still be needed at the end of the transition.

5 These sectors do not have a structural impact on the environment and therefore do not have to change their structural business models. However, they do need to adapt their practices and activities to the transition, an adaptation made possible by the changes in the actors most affected (e.g. the social and medical-social sector, education, administrations, etc.).

6 "Le capital patient. Un horizon pour la France et pour l'Europe" A. Bouzidi *et al.* Terra Nova, May 2016.

proportion of risky projects. However, given the amount of investment required and the public sector funding constraints that exist in all countries, private finance will be needed in developed economies as much as in others.

The issue is to know how to mobilize private finance as quickly and completely as possible.

1.2. What role can the different "private finance" actors play in the transition?

Private finance therefore has an active role to play in mobilizing finance for the transition. But this role depends on the typology of existing financing activities within private finance.

1.2.1. Financial actors have different roles in financing the economy

Generally speaking, we can distinguish two types of finance.[7]

Firstly, **"primary" finance** provides economic agents (non-financial companies, households, etc.) with funds to finance new investments. This finance category includes the following activities:

- Credit, distributed by banks, which is the main vector of monetary creation and increases the sums of financing granted to economic actors (except when simply an issue of refinancing pre-existing credit); [8]
- Private equity, which provides capital to companies that cannot access either financial markets or bank credit due to their size and/or the risky nature of their projects;
- The primary financial market (*i.e.* the issue of new shares or bonds) when these new funds increase the volume of financing available (and not simply the repayment of securities).

Secondly, **"secondary" finance**, which is a type of "second-hand market" of pre-existing financial assets that does not bring additional financing into the real economy (but only to financial actors). In this category, we include:

- The secondary market in financial assets (*i.e.* exchanges of existing shares and bonds), which is a zero-sum game: for an asset to be bought by one actor, it must be sold by another. While for the company issuing securities, there is no direct impact resulting from this change in the holders of these securities. Thus, exclusion or divestment policies have no direct impact on non-financial companies, while empirical studies struggle to demonstrate the existence of a significant indirect impact via prices (except in the case of large-scale collective initiatives). The main actors in financial markets can be found in the secondary market: those investing on their own behalf (sovereign wealth funds or insurance organizations, for example) or on behalf of third parties (pension funds, for example) and portfolio managers;
- Bank credit when it refinances pre-existing credit (whether it is interest rate renegotiation or debt rollover with maturity extension).

This typology of finance should not obscure the role of insurance activities per se. Indeed, these activities are supportive because most companies need to have insurance in order to operate. By assessing the risk when determining the insurance premium, insurers can steer a sector towards taking better account of environmental risks and thus act on the transition. They can also have an impact by ceasing to insure certain activities (those that involve fossil fuels for example).

Some financial actors are only involved in one area of finance (*e.g.* private equity actors are by nature associated with "primary" finance). Whereas other actors may participate in both sectors (for example, investors may take up newly issued financial securities or buy existing securities on the secondary market).

1.2.2. Each type of "finance" has a different role to play in the transition

"Primary" and "secondary" finance have roles to play in the transition. While both are essential, these roles are different. It is important to be very clear about the expectations we can have for both.

"Primary" finance has the most important direct impact on the transition, because it provides additional capital to make new projects possible (green or decarbonization projects) or, on the contrary, ceases to do so (stop financing new fossil fuel expansion projects, for example). Primary finance meets the additionality criterion which the vast majority of experts consider to be necessary for a financial actor to have an "impact" on the transition:[9] this means that funding is made available to projects that would otherwise not have been financed, which thus ultimately affects the amount of GHG emissions in the real economy.

Primary finance actors can therefore be expected to fulfil all three private finance roles in relation to the transition, as defined in the typology presented in section 1.1.

Consequently, banks and private equity firms have a key role to play in this area. This is also the case for actors (investors and portfolio managers in particular) involved in the issuance of new financial assets (shares and bonds).

In contrast, **"secondary" finance has no direct impact on the transition** in the sense of additionality, because it does not finance new assets but only "refinances" pre-existing financial assets.[10] Consequently, it cannot wholly fulfil the

7 See for example "L'illusion de la finance verte" by Alain Grandjean and Julien Lefournier – May 2021.

8 In the case of mortgages for the acquisition of old properties, the volume of financing increases, but they are applied to an existing stock of real assets. Their impact is therefore different but far from negligible in the case of transition. These mortgages can indeed be an opportunity to reinforce energy renovation operations.

9 See for example "Can sustainable investing save the world? Reviewing the mechanisms of investor impact" J. Kolbel *et al.* – Organisation & Environment 2020 or "The guide to classifying the Impact of an investment" Impact Management Project 2018.

10 Work carried out by actors in the Paris financial market on impact finance, under the aegis of Finance for Tomorrow, has retained three pillars to characterize this approach: intentionality, additionality and measurement. On this basis, this work estimates that the French impact investment market amounted to €4.4 billion at the end of 2019, including unlisted loans and assets but also listed assets that meet the definition. In any case, this is a "niche market" which does not challenge the idea that the vast majority of secondary finance activities do not have a direct impact on the transition. – "Definition of Impact Finance" Groupe de Place Impact – F4T September 2021.

three roles defined in the previous typology; even though this type of finance remains useful, its contribution is necessarily more limited. We can only expect the following functions from "secondary" finance actors:

- Putting pressure on companies that conduct activities that should be abandoned or drastically reduced (particularly in the fossil fuel sector). However, the method by which this pressure is exerted is subject to debate:[11] indeed important questions are being raised about the impact on the real economy (*i.e.* the emission levels of non-financial companies) resulting from divestment operations practised by certain financial market actors.[12] The preferred method now seems to be a policy of engaging (necessarily accompanied by an escalation strategy)[13] financial actors with non-financial companies to put pressure on them (through dialogue or voting at general meetings). These engagement policies can have an impact on the behaviour of companies but, without the direct leverage on financing, they are time-consuming and difficult to implement (notably because they require coordination between the various holders of securities).
- Indirectly supporting the decarbonization of companies and/or the development of facilitating and/or sustainable activities. Indeed, holding securities can ensure that a listed company (via a dynamic and therefore attractive stock market price) has easier access to advantageous financing conditions on the capital markets and can thus continue to finance the transformation already underway in its business model. In this way, financial actors accompany – rather than hinder – the transition undertaken by non-financial companies. It should be noted that this is what can ultimately be expected of most private initiatives advocating the alignment of their portfolios with a 1.5°C or 2.0°C pathway or with carbon neutrality,[14] particularly those encouraged by investors now part of the GFANZ group (see below).

It is important to emphasize the consequences that can be drawn in terms of implementing the relevant indicators for monitoring the actions of different types of finance. Indeed, different instruments will be needed to assess the mobilization of the different categories of financial actors:

- For those involved in "secondary finance", the overall indicators for assessing alignment[15] – over and above the many questions raised on the methodological level – aim primarily to measure the consistency of financial portfolios with the evolution of the economy in terms of transition.[16] To a large extent the same applies to the indicators used to assess the pathways of financial actors towards carbon neutrality (reduction of the carbon footprint of portfolios and of the carbon intensity of financed companies). Thus, the indicators associated with impact/contribution measurement here should cover the engagement policy, the organization of coalition actions, the escalation strategy and the voting and divestment policy. A monitoring, reporting and verification process should be associated with each of the above categories.
- For "primary finance" actors, such alignment or carbon neutrality indicators do not enable the assessment of the real contribution in relation to what they are able to do. Two aspects should therefore be given priority: firstly, the analysis of the quality and monitoring of the instruments used (primarily transition plans, which enable the understanding of the overall strategy and resources mobilized by financial actors)[17] ; and secondly, the use of impact indicators (*e.g.* the evolution of the portfolio structure with regard to the European taxonomy, or the share of property portfolios that have benefited from energy renovation financing compared to national targets, or the share of financing granted to companies that have made credible commitments – validated by third parties – in favour of the transition and that have actually been implemented).

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11 See for example a recent analysis of the respective roles of exclusion, divestment and engagement policies: "Making Finance consistent with climate goals?" New Climate Institute, November 2022.

12 The shares sold in the context of a divestment operation are in fact necessarily acquired by other actors who are more often than not less scrupulous with regard to the climate than the financial actors selling them.

13 "Barriers to Impact – Exploring barriers to the implementation of impactful climate actions by Asian Financial Institutions" WWF 2DII December 2021.

14 Carbon neutrality can be defined as a state where residual CO2 equivalent emissions are permanently sequestered so that the concentration of greenhouse gases in the atmosphere is stabilized.

15 These indicators measure the alignment of portfolios to a temperature trajectory, typically 1.5°C or 2.0°C. The scenarios used as a reference do not necessarily correspond to a carbon neutral situation.

16 See for example "The alignment cookbook: a technical review of methodologies assessing a portfolio's alignment with low-carbon trajectories or temperature goal" – J. Raynaud *et al.* – ILB August 2020.

17 See for example "Include mandatory banking transition plans with Pillar 2" J. Evain and C. Calipel – I4CE April 2022.

THE DIFFERENT ROLES OF FINANCIAL ACTORS IN THE TRANSITION

	"Primary" finance	"Secondary" finance
Definition	Providing economic agents with additional financing to make new investments	Refinancing of existing financial assets without additional direct financing in the real economy
Activities covered	- Private equity - Bank credit - Primary financial market	- Secondary market for financial assets - Refinancing of pre-existing bank loans
Impact on transition	Most significant impact on the transition in terms of additionality (enables new projects)	No direct impact on the transition in terms of additionality
Roles	- Ending the financing of high-emission activities, - Providing new financing for "sustainable" companies and "climate" solutions - Financing new decarbonizing activities of companies	- Putting pressure on companies engaged in activities that must be abandoned or transformed - Supporting the financing of companies, particularly by improving their attractiveness, that have already engaged in the transition
Monitoring indicators	- Climate strategy (in lending or in primary market investment) and definition of a credible transition plan - Impact indicators on reducing harmful financing, sustainable financing and decarbonization financing	- Assessment of the alignment or carbon neutrality of financial portfolios - Engagement and escalation policy, coalition actions and voting policy

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Finally, an apparent paradox must be highlighted: it is those actors who are primarily involved in secondary finance who are the most committed and active regarding "responsible finance", with considerable sums of capital under their management, even though their potential impact is the most limited. For example, the recent CDP report[18] indicates that its Science Based Target campaign was supported by 27% of GFANZ portfolio managers and investors, but only 6% of NZBA banks.

This paradox raises questions about the real impact that can be expected from the voluntary initiatives of private financial actors.

18 "CDP Science-Based Targets Campaign: Final progress report: 2021-22 campaign" CDP September 2022.

2. VOLUNTARY INITIATIVES WILL BE INSUFFICIENT TO MOBILIZE PRIVATE FINANCE

The recent period has been characterized by the emergence of a large number of private initiatives, the stated purpose of which is to lead the different categories of financial institutions to provide the financing needs required by the transition to a carbon neutral economy. For example, in May 2019, IIGCC [19] launched the Paris Aligned Investment Initiative (PAII) to enable investors to align with the Paris Agreement goals, while in September 2019 another investor group created the Net Zero Asset Owner Alliance (NZAOA) to drive investors towards carbon neutrality. In April 2021, ahead of COP 26, this development reached its peak and affected all financial actors with the creation of Mark Carney's Glasgow Financial Alliance for Net Zero – GFANZ, which brings together a large number of major financial institutions managing a considerable amount of capital within seven member alliances [20] (in Glasgow, it was announced that there were 500 financial institutions managing $130 billion in assets).

It would, however, be a mistake to assume that these voluntary private initiatives will be a decisive force in mobilizing private financial actors to the necessary extent. Such initiatives are affected by several limitations which, despite the considerable sums of money mobilized on paper, greatly reduce their effectiveness.

2.1. The voluntary nature of these initiatives

The voluntary nature of these initiatives leads to several weaknesses.

Firstly, these initiatives are launched by different categories of financial actors, who define their own approaches, objectives, indicators, etc., leading to:

- **considerable heterogeneity in the methodologies used, which suffer from numerous weaknesses:** transition scenarios of varying degrees of ambition, limitation in terms of emission scopes covered (particularly the total or partial absence of scope 3), targets that use different metrics, differences in the consideration of carbon capture and storage mechanisms and of off-setting mechanisms, etc.
- **questionable levels of actual ambition:** use of targets that are more often related to carbon intensity than to reductions of financed GHG emissions,[21] overly optimistic assumptions about the effectiveness of carbon capture and storage technologies, frequent absence of targets in terms of reducing fossil fuel financing, etc.

Many observers have studied these characteristics [22] and their analyses remain relevant today, even if it must be recognized that initiatives, notably under the aegis of GFANZ, have endeavoured to correct certain weaknesses, and that adopted approaches are now more global (see the role of the transition plans recommended for moving towards carbon neutrality: financing i) companies that are already aligned, ii) the technical solutions necessary for the transition, iii) the transition of GHG-emitting companies, and iv) the organized and gradual withdrawal of high-emitting assets).[23]

Furthermore, these types of voluntary initiatives are inherently unable to "sanction" members who sign up to commitments but fail in their implementation. It is therefore impossible to ensure that commitments made are actually met, while initiatives have to rely on the effectiveness of "market discipline" to hope for the implementation of commitments.

Finally, those who participate in these initiatives have the power to call for commitments to be reduced if they consider them to be excessive. Such initiatives are thus structurally inclined to find agreements on "lowest cost" proposals. This was illustrated by the recent threat by several large US banks to withdraw from GFANZ on the grounds that some fossil fuel commitments put them at risk of legal action in US courts under anti-trust laws. This threat led GFANZ to distance itself from the UN's Race to Zero initiative because of its targets for reducing fossil fuel financing.[24] The latest publication of the Net-Zero Insurance Alliance illustrates this relaxation of recommendations and member commitments.[25][26]

The recent UN HLEG report [27] presented at COP27 is expected to further reinforce this gap, clarifying the conditions for a Net-Zero pledge, which require:

- Commitments to end dependence on and support for all fossil fuels, including "new natural gas supplies and LNG exports", without limitations or loopholes. Net Zero plans must not support the expansion of fossil fuels.
- Becoming a member of trade associations that are committed to achieving the 1.5°C pathway with little or no overshoot.

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19 The Institutional Investors Group on Climate Change.

20 Net Zero Asset Owner Alliance, Net Zero Banking Alliance, Net Zero Asset Manager, Net Zero Insurance Alliance, Paris Aligned Asset Owners, Net Zero Financial Service Providers Alliance and Net Zero Investment Consultants Initiative.

21 In all cases of reduction (intensity or absolute), these are financed emissions and therefore the question arises whether this leads to a reduction in GHG emissions in the real economy or whether this reduction in financed emissions is due to a reallocation of the portfolio. See section 2.2.

22 "It's not what you say, it's what you do" Reclaim Finance November 2021 – "The problem lies in the net" Finance Watch June 2022.

23 ''2022 Progress Report" GFANZ.

24 The Target Zero campaign, launched in 2021 by the United Nations, mobilizes over 11,000 non-state actors to support the implementation of carbon neutrality through immediate and rigorous action. In June 2022, it specified that its members were committed to reducing and phasing out financing for fossil fuels, including a commitment to stop financing new operations, including coal.

25 "Net-Zero Insurance Alliance Target-Setting Protocol", version 1.0 for public consultation, October 2022.

26 "For the avoidance of doubt, NZIA members are under no obligation to continue their relationship with NZIA and, while this document may propose general measures and best practices on how to set and pursue individual targets, NZIA members shall, at all times, each remain free to determine and implement their respective decarbonization strategies independently and unilaterally."

27 "Integrity matters: Net Zero commitments by businesses, financial institutions, cities and regions" United Nations' High-Level Expert Group, November 2022.

- Carbon credits not to be counted towards the interim emission reductions needed to achieve a net zero pathway.

Failure to meet the conditions for a Net-Zero pledge will leave GFANZ members open to accusations of greenwashing.

2.2. The inadequacy of this approach in relation to the different roles of financial actors

In their respective methodologies, the initiatives, particularly those gathered within GFANZ, take into account the differences between the activities of the various financial actors (investors, portfolio management, banks, insurance organizations, etc.). But the approach adopted by these different initiatives does not take into account the different roles of primary and secondary finance.

The public debate on initiatives has so far focused on their flawed methodologies and their actual levels of ambition. However, we also need to ask more fundamental questions about this type of approach: what is the relevance of the "carbon neutrality" concept for a financial company? This concept – the conditions of which the IPCC specified in its 2018 report[28] – only takes on its full meaning at the societal level and that of the economy as a whole. Its application at the company level must be carried out with caution, as the French Agency for Ecological Transition ADEME[29] has indicated. It appears that an individual entity cannot be carbon neutral on its own: it can essentially "contribute" to the transition to a carbon neutral economy.[30] For a non-financial company, this contribution is mainly achieved through the reduction of its own GHG emissions or those of other actors enabled by its activity.

But what about financial actors? Almost all of their emissions are scope 3, *i.e.* they do not come from their own activities but from the clients they finance ("financed emissions"). How can non-financial companies best contribute to the transition: is it simply by reducing financed emissions (without verifying whether this reduction corresponds to emission reductions in the real economy or to a simple reallocation of the portfolio) or is it by financing the economic transition itself, which does not necessarily – or at least not immediately – translate into a reduction in financed emissions?[31] It is clear that financial actors are expected to play the latter role, even if it means temporarily foregoing a reduction in their funded emissions.

Moreover, this approach to the concept of carbon neutrality was first developed by and for financial market actors (investors and asset managers). These approaches and methodologies were then applied to other financial actors (notably banks and insurance activities). This was carried out without accounting for the different roles played by these financial actors (see section 1 of this note).

Ultimately, this carbon neutrality approach applies mainly to "secondary" financial actors, who by nature have a relatively limited role in the transition. In fact, the methodologies are aimed more at "accompanying" the transformation of non-financial actors, rather than at having a real impact on the transformation. The approach aims to help financial market actors evolve at the same pace as the economic transformation and, if possible, create a "price signal" that can facilitate access to financing for companies that have already embarked on the transition. To have greater expectations is therefore delusional.

Conversely, this approach does not seem to be sufficient as a way to encourage "primary" finance actors (especially banks) to play a more active role in economic transformation.

2.3. Structural obstacles to the effectiveness of voluntary approaches by financial actors

The intrinsic characteristics of wider financial markets prevent financial actors from rapid transformation and from being proactive in the transition.

Indeed, they are faced with a double paradox:

- The risk-return trade-off currently predominates decision-making among financial actors compared to other considerations. However, there is an intrinsic contradiction in seeking to be proactive in favour of the transition while trying to maintain the risk-adjusted financial returns currently expected on the financial markets. Indeed, it would be necessary for actors to abandon activities that are highly profitable in the short term in favour of more uncertain financing, which would be less profitable with potentially more distant returns, not to mention running the risk of creating stranded assets. To overcome this paradox, financial actors tend to accompany the anticipated economic changes (especially when new activities have reached a phase of maturity where good profitability is ensured) rather than being proactive in favour of the transition.
- Numerous academic analyses and market experience show that the decisions of financial actors are marked by a very strong bias towards short-termism (even among actors who should have a longer-term vision). This short-termism of financial actors is in contradiction with the medium and long-term horizon that characterizes the transition.[32]

These characteristics lead the market to finance the economy as it exists rather than the economy of the future. This favours an analysis centred on past performance with the aim of replicating it in the short term, especially given that there are lower costs involved in financing transactions that are already known and understood. However, financing the transition is intrinsically different from financing other activities: it has a fundamental uncertainty and a long-term horizon. It is therefore difficult for market mechanisms alone to internalize the externalities associated with climate change. In other words, the market alone cannot solve these major failures and public intervention is essential.

For financial market actors, the abovementioned paradoxes are embodied in an overly narrow acceptance of their fiduciary responsibility to simply maximize short-term risk-adjusted

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28 "Special Report on Global Warming of 1.5°C" IPCC 2018.

29 ADEME Position paper – "Carbon neutrality" May 2022.

30 "10 Principles for an ambitious corporate climate strategy" Net Zero Initiative June 2022.

31 "Net zero commitments need to prioritize impact" S. Bendahou I4CE, October 2022.

32 ''Breaking the tragedy of the horizon'' speech by Mark Carney, September 2015.

financial returns. This fiduciary responsibility argument, based on a risk calculation that does not currently include climate risk, thus serves as a pretext for the continuation of old financing practices.[33] While other financial actors (such as banks or insurers) are by nature not subject to the fiduciary responsibility, they are confronted with the shareholder requirement of value creation, which also requires the short-term maximizing of financial returns (particularly in terms of dividends). All financial actors are thus prisoners of investor expectations for high rates of return which limit their sustainable investments.

2.4. A short-term risk approach that does not cover all issues or their importance

The international voluntary initiatives of financial actors retain a simple financial materiality approach, *i.e.* an approach based on financial risks. However, such an approach cannot guarantee a contribution to the achievement of the transition objective for the economy. Indeed, there are two pitfalls to be highlighted:

- A traditional risk-based approach, given the difficulties of fully integrating climate risks into standard risk assessment approaches,[34] means that the financial risks currently calculated are much lower and secondary to the economic and social risks. A financial institution may thus feel that it has its risks under good control, or even that it is very well covered due to insurance mechanisms, but in fact passes its risks on to society.
- The short-term prudential framework (*e.g.* one-year default probabilities for banks and insurance companies), which is appropriate for traditional financial risks, is largely unsuitable for dealing with the long-term nature of the transition and physical risks.

Overall, private voluntary initiatives are clearly useful and should be supported; they allow economic transformation to be accompanied and to contribute to the awareness of non-financial companies that lag behind in terms of commitment policies. However, due to their intrinsic limitations, they will be unable to contribute significantly to the financing of the transition (too little, too late). The pace of the involvement of financial actors is in fact highly insufficient, including in regard to taking the necessary steps prior to practical climate action. For example, the World Benchmarking Alliance points out in its latest report[35] that only 37% of the major financial institutions evaluated have published long-term net-zero objectives, 2% of which have been translated into intermediate objectives for an institution's entire financing activities.

The question therefore arises: who can accelerate the shift in private finance?

33 It should be noted that an alternative approach to modifying the risk/return trade-off would be to adopt an accounting system that includes negative environmental externalities.

34 "Scenario analysis of transition risk in finance" Romain Hubert *et al.* I4CE May 2022.

35 "2022 Financial System Benchmark", World Benchmarking Alliance, https://www.worldbenchmarkingalliance.org/publication/financial-system/

3. A FIRM COMMITMENT FROM PUBLIC AUTHORITIES IS ESSENTIAL TO MOBILIZE PRIVATE FINANCE

A stronger commitment from public authorities than is currently the case is needed to overcome the structural obstacles encountered by the voluntary measures of private financial actors.

Similarly to other economic agents (non-financial companies and households in particular), private finance actors need clear signals and strong incentives to move towards transition. The public authorities must implement an economic and regulatory framework, based on a clear transition strategy that can serve as a reference for all public and private actors in the various sectors of the economy.

3.1. Policies and instruments to be mobilized to promote transition

This firm commitment must involve public authorities in the broadest sense (government, public financing bodies, regulators, central banks and financial supervisors). It must be based on a closely coordinated [36] use of all available instruments, aim for maximum efficiency and respond to the climate emergency.

These policies include:

- Determining a central transition pathway and sectoral variations, which in France is now referred to as "ecological planning";
- Establishing binding rules for economic actors (*e.g.* environmental standards);
- Implementing incentive tools (budgetary and fiscal);
- Providing "patient" public financing (*i.e.* long-term and a willingness to accept lower returns), either directly or through public financial institutions or public-private financing arrangements that incorporate risk sharing,
- Integrating climate objectives into the implementation of monetary policy,
- Establishing a regulatory and prudential framework to guide private financial actors towards action in favour of the transition (without seeking to "administer" the financing of the economy).

3.2. Instruments to support transition financing

Within the overall economic framework set by the public authorities to promote an orderly transition, the main points of which are outlined above, particular attention must be paid to the instruments to be used to finance the transition.

Indeed, to finance the transition, there is a need to move away from a market-fixing approach, primarily by improving the information available, towards a market-shaping approach.[37] The former is based primarily on the notion that better information will enable the market to play its role. The latter is based on the view that the market alone will be unable to overcome the obstacles to transition.

This new approach to structuring the market must address both public and private finance. It should:

- Rely on a long-term public investment strategy that accepts more risk and provides long-term finance with lower returns than the private sector ("patient finance");
- Develop a coordinated public action to mobilize transition finance from private actors. The objective of this financing policy is not to establish an authoritarian allocation of financial flows in the framework of a managed economy. But rather to create a strategic framework to ensure that the private financial sector supports and contributes to the strategic priorities of public authorities in terms of the transition (transformation of infrastructure, industrial decarbonization, energy renovation of buildings, etc.) and not only that it "accompanies" non-financial companies in the transition. It must also avoid financing that favours carbon lock-in (which goes against strategic orientations), and finally stop the financing of certain activities, and to organize the orderly management of stranded assets.

Financial and prudential regulation must play an important role in this financing policy.[38] As mentioned above, public policies must be coordinated and "linked" with each other. This is particularly true of financial and prudential regulation: it cannot do everything on its own but it is part of the "toolbox" available to public authorities. It should not compensate for the absence of other policies (which would condemn it to failure) but should be used to complement other economic policies that target the financial sector, with the objective of improving their overall effectiveness. It must therefore be coordinated and consistent with other public actions. It must mobilize all available levers to drive the financial sector towards the structural transformation of its financing, so as to i) limit the systemic risk resulting from climate change and ii) play its full role in financing the transition.

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36 See for example "The Green Swan – Central banking and financial stability in the age of climate change" Bolton *et al.* BIS January 2021.

37 ''Green New Deal" K. Edwards and J. Ryan-Collins – 2021.

38 "Can Financial Regulation accelerate the low-carbon transition?" J. Evain and M. Cardona I4CE, January 2021.

CONCLUSION

Despite the claims, the large sums of assets involved, and the undoubted goodwill of many actors, voluntary initiatives of private actors face powerful intrinsic challenges. While beneficial and worthy of encouragement, we cannot expect these initiatives to deliver more than they are realistically capable of achieving. Indeed, it appears that they are incapable of making a decisive and rapid contribution to the financing of the transition and that the transition from Net-Zero pledges to actions will be long and insufficient.

This observation leads us to call for a stronger commitment from the public authorities. As for other economic agents, this commitment will be decisive in mobilizing private finance for an orderly transition. A public debate must be launched regarding the instruments needed to compensate for market failures and to encourage private financial actors to play their various roles to the full. This debate should focus on the commitment of public authorities in general and on the role of financial regulation in particular, which cannot do everything on its own – quite the contrary – but must be given an important place among the instruments used.

DISCLAIMERS

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The Institute for Climate Economics (I4CE) is a Paris-based think tank with expertise in economics and finance with the mission to support action against climate change. Through its applied research, the Institute contributes to the debate on climate-related policies. It also publishes research to support financial institutions, businesses and territories in the fight against climate change and that assists with the incorporation of climate issues into their activities and operations. I4CE is a registered non-profit organisation, founded by the French National Promotional Bank Caisse des Dépôts and the French Development Agency.

The financial system needs to put climate considerations at the heart of its operations, in order to participate in the transition to a low carbon and climate-resilient economy while managing the climate risks to which it is exposed. In order to achieve this objective, **the Finance ClimAct project** will develop the tools, methods and new knowledge necessary for savers to integrate environmental objectives into their investment choices, and for financial institutions and their supervisors to integrate climate issues into their decision-making processes and to align financial flows with energy climate objectives.

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