SunTec

# Drivers and Emerging Trends in Sustainable Finance

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The climate crisis is worsening and it now more urgent than ever for the world to come together to fast-track action against climate crisis. Environmental, Social and Governance (ESG) is now a critical focus area for most corporates today and the banking and financial services sector has an important role to play here. Sustainable finance accounts for the ESG factors of any project or activity when considering investments. Through these practices, the sector can not only fund sustainable projects but also highlight environmental and social elements in business. SunTec Confluence 2022 focused on the Drivers and Emerging Trends in Sustainable Finance with a closing keynote address by Ben Caldecott, Founding Director of the Oxford Sustainable Finance Program.

## Key Drivers

Sustainable finance is an emerging field, shaped by factors in the macro environment such as climate change. Some of the key drivers shaping the business of sustainable finance include:

**Risk:**
The world is facing unprecedented climate risk. As emissions and global temperatures continue to escalate, humanity faces a deep crisis. Extreme weather events, water scarcity, rising sea levels, melting icebergs, and agricultural disruption are just some of the effects of climate change that we are witnessing, and these are likely to worsen without urgent action to mitigate global warming. This, without a doubt, is one of the biggest risks facing the world today and one of the key drivers of sustainable finance. But even action to combat climate change gives rise to transition risks. As organizations scramble to meet the net zero goals laid down by the Glasgow Climate Pact, they face the risk of disruption – social, labor and talent, policy, technology, and more fronts. The risk landscape is darkening as both action and non-action against climate change present significant risk.

**Opportunity:**
Despite the risks, the transition to a lower carbon economy also holds some opportunities for the financial sector. This move is capital intensive with OPEX systems changing to CAPEX systems. For example, when one bought a regular fossil fuel powered car, the cost of the car was a one-time expense with fuel costs being a running expense. But as the world pushes ahead to meet the net zero goals, it will need more CAPEX investments such as the cost of setting up windfarms, solar parks, electric vehicle infrastructure and manufacturing cost. According to the International Energy Agency, investment in clean energy must reach USD 4 trillion by 2030 and well over USD 100 trillion over the next three decades.[1] This is a sizeable opportunity for the financial sector.

**Client, Investor and Employee Demand:**
Retail customers as well as large institutional investors are increasingly demanding accountability on the ESG front from their banks. They want to make a difference to burning issues with their money and this trend is more prominent amongst younger people and women with wealth to invest. There is increasing pressure from shareholders on ESG action. Stakeholders want organizations to stop lending to fossil fuel companies, want to ensure that the organization follows through on its sustainability objectives. And employees want to increasingly work for companies who have a strategic view and focus on sustainability. They are looking to associate with organizations whose value and actions match their own beliefs. Sustainability is now a critical consideration for employee recruitment and retention.

**Supervision and Regulation:**
As climate risks evolve, so do regulatory frameworks. Central banks require organizations to have systems and governance in place to manage increased risk. There are already some significant climate regulations in place, like the Climate Risk Stress Test in Europe and UK. How companies respond to these will shape future regulations in relevant markets.

**Policy Aims and Financial Centers:**
There is increased pressure on organizations to meet policy objectives. Policy makers need funds to flow into solutions to environmental challenges if they must meet their net zero targets. There is now increased policy interest and incentives for banks to increase sustainable finance investments. And as competition within the sustainability solutioning and financing space increases, policy makers and regulators are doing their best to create an environment that allows everyone to succeed.

**New Frontiers:**
The key word here is complexity. The world is just beginning to understand environmental issues and have only just started integrating sustainability practices into financial decisions. Risks feed off each other and each risk has layers of complexity that need to be addressed. Building resilient enterprises, and a resilient world, dealing with the vagaries of nature, these are new challenges that the financial sector will have to learn to address.

## Headwinds for the Segment

Today there is widespread understanding of the risks posed by climate change and there is accelerated action to address them. But there are also some lingering challenges that are slowing down the momentum. First there are climate deniers or at best, minimizers who refuse to accept or acknowledge the threat and actively downplay its seriousness.

There is also a tendency to conflate ESG with sustainable finance though they are not the same. Sustainable finance considers ESG metrices when making investment decisions. Greenwashing is another significant challenge that the sector must overcome. There must be greater focus on due diligence and monitoring of ESG investments and commitments. In recent months, there has been significant rotation in ESG funds, especially in the US where ESG funds are tied in with tech stocks that have underperformed. But this has led to a healthy debate about what ESG scores and ratings must be – measuring and how they can be monitored. For example, an organization may put in place a deforestation policy and get good ESG ratings, but they may be buying unsustainably sourced timber illegally. There are no mechanisms in place to check such instances, which undermines the ratings system. The good news is that there is now better understanding of the nuances of ESG and sustainable finance. Maturing markets, greater scrutiny, and increased sophistication in ESG practices are spurring positive changes for sustainable finance. Earlier marketing around responsible investing focused on messaging around making the world a better place, which is not what sustainable finance is about. Today most stakeholders can ignore this misleading messaging and they understand that it is about embedding ESG factors into financial decisions to ensure better risk adjusted returns.

Action on climate are change and organized focus on ESG are still relatively new areas for the financial sector. There are risks and key drivers impacting it, and understandably there is some disruption. But every challenge before the sector is contributing to changing the conversation, and driving better policies, practices, and outcomes.