The Banker
GLOBAL FINANCIAL INTELLIGENCE SINCE 1926

April 27, 2023
United Kingdom
by Nuno Fernandes

SUSTAINABILITY

Climate change and finance: how two seemingly separate worlds connect

Nuno Fernandes | 27/04/2023 9:17 am

Image: Getty Images

How should trillions in private capital be deployed to tackle climate change and finance a green transition? By Nuno Fernandes.

Climate change is already affecting human life, but the worst effects are yet to come. Tackling the growing challenges ahead will require that companies and financial institutions connect on climate change in increasingly innovative ways.

Finance is about linking demand for capital (typically companies) to suppliers of capital (such as investors and financial institutions).

Defined in this broad sense, finance – including shareholders, debt holders, capital markets, regulators/central banks and boards – has a major role to play in fighting climate change.

Importantly, for financial institutions there is an opportunity to develop novel products that their customers are demanding. However, the changing climate and the public policies related to it pose risks to companies, banks, governments and investors.

These are some of the questions analysed in my new book, *Climate Finance*. Financial decision-making and climate-related risks are inextricably linked, and the relationship between them will be key to achieving climate transition.

It's a two-way street
Climate impacts finance. Climate change affects companies' fundamentals and thus markets overall. It brings new risks and opportunities for companies, with obvious financial implications.

Investors do care, and are engaging with companies on disclosure, stress tests, exposure to stranded assets and low-carbon transition strategies.

But finance also impacts climate. Calls for climate action come from company stakeholders, world leaders and regulators, as well as from investors. This feeds demand for environment-related financial instruments.

Different finance tools – new ESG (environmental, social and governance) metrics, green bonds or sustainability-linked loans (SLLs), for example – all help companies take concrete actions to reduce their carbon footprint.

Therefore, it goes both ways: each impacts the other.

New financial reality
BlackRock chairman and CEO Larry Fink, in his annual letters to shareholders, was among the first to raise the alarm: companies must deal with the climate crisis.

But Mr Fink is not alone. Many long-term investors are worried that failure to act could endanger returns on their assets. And the cost of not acting will outstrip the cost of acting now.

THE COST OF NOT ACTING WILL OUTSTRIP THE COST OF ACTING NOW

More and more companies are realising their assets are not safe for the future. Some will need to be written off entirely. While countries in Asia and the Global South will be disproportionately affected, developed nations like the US will also face adverse consequences.

Beyond extreme weather events such as flooding, there will be increased inflation, supply chain disruptions, healthcare costs and productivity issues.

Globally, different sectors face different degrees of risk in the green transition. Those that contribute most to CO_2 emissions (such as transportation and food) will be harder hit than others.

Changing policies, such as new regulations and restrictions on the use of certain resources, will impose transitional costs on these sectors.

Top executives and boards will need to carefully factor possible impacts across different parts of their firms' operations.

Incorporate upcoming risks, including climate
Amid the increasingly clear and dire toll of climate change, and given the lack of public funds to support an energy transition of dramatic scale, private investors are being called upon to help foot the bill and avert, or at least diminish, future weather-related catastrophes.

The surging demand for green bonds is a positive step towards this transition. Yet the magnitude of the climate challenge means we cannot rely on green bonds alone. To enact real change, banks must also incorporate climate issues into loan conditions.

TO ENACT REAL CHANGE, BANKS MUST ALSO INCORPORATE CLIMATE ISSUES INTO LOAN CONDITIONS

That is where novel forms of bank financing products come into play. A green loan is granted by an authorised credit institution to an individual or company to finance a green project.

Sustainability-linked loans are loan instruments that incentivise borrowers to achieve green objectives. Their terms are linked to the borrower's sustainability performance as measured by predefined ESG criteria. Enhanced sustainability performance lowers the interest rate, while unmet targets can lead to a rate spike.

In terms of the sustainability incentives attached to SLLs, banks are often willing to lower interest rates for companies making bigger green strides.

AB InBev's $10bn SLL included a pricing mechanism encouraging progress in water efficiency in global breweries, in plastic bottle recycling, in renewable energy sourcing and in greenhouse gas emissions. The loan, from 26 global banks, features an agreed margin grid whereby the actual interest rate charged depends, in part, on these four climate-related KPIs.

Finally, banks will have to assess evolving risks, in particular environmental risks. Over the next few years, banks will be incorporating physical and transition climate risks into their models, risk management and businesses (including the pricing of financial products).

Capital markets and investors will also play a role in financing the transition and redirecting capital flows to sustainable projects. Corporate governance, shareholder activism and an engaged board of directors are all key to guiding business to more sustainable outcomes.

Meanwhile, where ESG is appropriate, the right metrics must be applied to assess climate risk vulnerability and the sustainability of projects.

New demand and markets will inevitably arise from changes in technology, consumer reactions and even resource restrictions, which themselves will power innovation.

Those companies and financial institutions that are prepared will be able to cater to these new market needs.

Critical thinking, a focus on the levers of value and proper due diligence trumps celebrity involvement.

Nuno Fernandes is professor of finance and governance at IESE Business School, and author of Climate Finance, a new book featuring evidence from markets, academic research and practical case studies of leading companies and investors.

The book provides an in-depth understanding of the various aspects of climate finance, from the risks and opportunities to the demand and supply of capital, to the impact of global policies.