Sustainable Finance and Green Banking Initiatives.

What is sustainable finance?
Green banking and sustainable finance have emerged as critical tools for solving issues such as environmental degradation, social inequity, and governance deficits.
Sustainable finance describes a financial investment framework that incorporates environmental, social, and governance (ESG) factors, guiding funds towards activities that promote sustainable economic endeavours.[1] Multiple stakeholders have stressed the importance of corrective measures and the transition to a more sustainable economy. Many countries' broad endorsement of the objectives set forth in the 2016 Paris Climate Agreement on Climate Change has given rise to new political agendas characterised by significant resource reallocation and increased investments in low-carbon, green economies. [2]
Green financing is the subfactor within sustainable finance, and defined as investment strategy which is aimed to address climate change adaptation and mitigation with broad scope of environmental goals (Figure 1.1). [2]

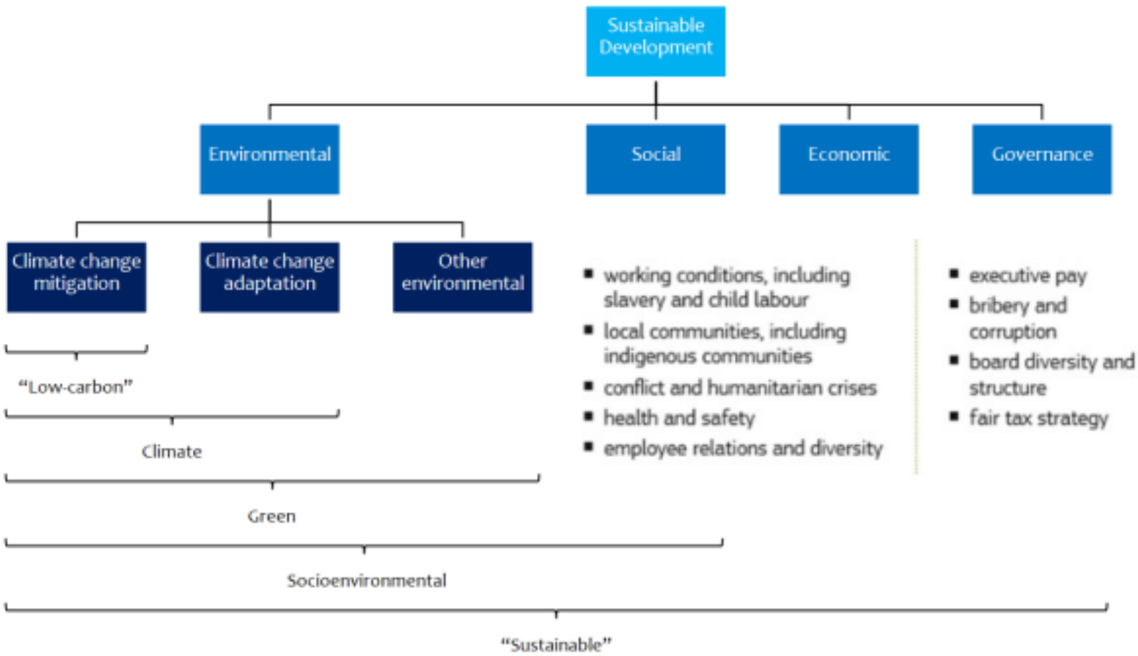

Figure 1.1 Sustainable finance mapping and simple definitions
Source: Elaboration on Definitions and Concepts: Background Note, UNEP Inquiry, 2016.

Environmental factors include climate change mitigation, resource depletion, waste, and deforestation; social factors include huma rights, modern slavery, child labour and employee relations; governance factors include bribery and corruption, executive pay, board diversity and tax strategy. These factors may impact the risk, volatility and long-term return of securities and markets. [3]

1 European Union (2022) *Overview of Sustainable Finance, European Union*. Available at: https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en [Accessed: 29 March 2024].
2 European parliament (2022) *Green and Sustainable Finance, European parliament*. Available at: https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/679081/EPRS_BRI(2021)679081_EN.pdf [Accessed: 29 March 2024].
3 Schoenmaker, D. and Schramade, W. (2021) *Principles of Sustainable Finance*. Oxford: Oxford University Press.

In the European Union's policy framework, sustainable finance denotes financial activities aimed at fostering economic development while simultaneously alleviating environmental burdens, thereby contributing to the achievement of the climate and environmental goals outlined in the European Green Deal, with due consideration given to social and governance dimensions. [1]

Importance of integrating sustainable financing

Schoenmaker and Dirk describes following 6 reasons for why financial institutions integrate sustainable financing in their operations. [3]

1. Risk perspective:

EY report found that 52% of the banks view environmental and climate change as key emerging risk. [4] Physical risks can potentially lead to financial ramifications for both households and organizations, encompassing direct harm to assets as well as indirect consequences stemming from disruptions in the supply chain, this increases the borrowers credit risk and could potentially lead to liquidity risk and maturity mismatch for the financial institution. [5]
Transition risk which relates to the regulatory changes due to the decarbonisation process will have significant impact on bank's portfolios and will impact its financing as well. Moreover, from the demand side, customers are shifting to more green and sustainable purchases and the sustainable lifestyle awareness is increasing among younger population, thus businesses are start shifting to openly disclose their sustainability reports and build their brand. The younger generation's growing involvement as active bank customers and investors is fuelling the anticipated rise in the use of green banking solutions. [4]

2. Fiduciary duty perspective

The misconception that fiduciary duty obstructs the consideration of ESG factors stems from the belief that these factors lack financial importance. Despite investors relying on fiduciaries to act in their best interests, traditionally defined in financial terms, the 2019 Principles for Responsible Investment (PRI) report argues that modern fiduciary duties require the integration of financially significant ESG factors into investment decisions, aligning with the obligation's timeframe. Additionally, fiduciaries should acknowledge and incorporate the sustainability preferences of beneficiaries or clients, regardless of their financial significance.

3. Economics perspective

Recognition of the economic ramifications of environmental issues and social challenges is growing, as sustainable development aims to ensure the availability of resources such as food, water, and healthcare for future generations without straining Earth's systems, while also addressing the risks of surpassing planetary boundaries.
In 2017, Kate Raworth introduced the Doughnut concept, which defines the bounds for both societal foundations and planetary constraints. It depicts the optimal place for humanity, which lies between the social foundation that ensures human well-being and the ecological ceiling that limits planetary pressure (Figure 1.2).

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4 EY (2020) *How banks are defining and internalizing sustainability goals*, *EY*. Available at: https://www.ey.com/en_us/banking-capital-markets/how-banks-are-defining-and-internalizing-sustainability-goals [Accessed: 29 March 2024].

5 Bank of England (2024) *Breaking the tragedy of the Horizon - climate change and financial stability - speech by Mark Carney*, *Bank of England*. Available at: https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability [Accessed: 29 March 2024].

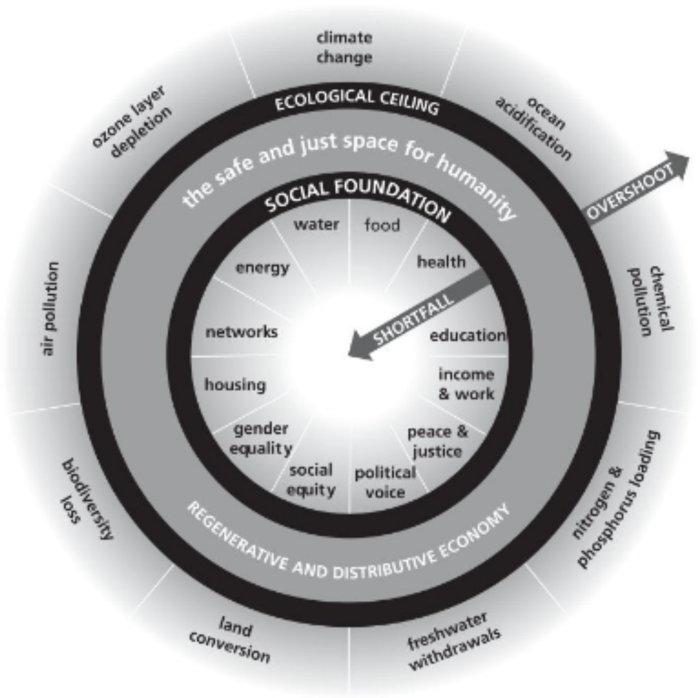

Figure 1.2 *The doughnut: the safe and just space for humanity*
Source: Raworth (2017)

4. Impact and ethics perspective

Investors are shifting into more impact driven investments and believe that financial return is not the only incentive. Avoiding investments with negative impact has ethical and financial consequences for the investors thus avoiding these investments provide less risk for the investors.

5. Client demand

Clients such as pension fund beneficiaries are increasingly calling for greater transparency about how and where their money is invested and requires their investments to be made into sustainable investments with positive impact or at least avoid negative impact as people are more aware of the value drivers of the sustainable finance.

6. Regulatory perspective

In the last two decades, the top 50 largest economies globally have implemented more than 730 policy revisions, both through formal legislation and informal guidelines, aimed at incentivizing or mandating investors to consider long-term value drivers, which include Environmental, Social, and Governance (ESG) factors.

Trends in sustainable finance

Many studies have been conducted regarding the amount of financing required to achieve the net-zero transition. For instance, Bloomberg estimates that the global economy will need $200 trillion in total over the next three decades to transition to net-zero economy (Bloomberg Terminal). Meanwhile, the Global Commission on Economy and Climate estimates $26 trillion injection is required by 2030 to reach the net-zero goals.[4] Net-zero refers to the state where the greenhouse gas emission is not added to the total amount already existing in the atmosphere. [6]

6 BBC (2023) *What is net zero and how are the UK and other countries doing? BBC News*. Available at: https://www.bbc.co.uk/news/science-environment-58874518 [Accessed: 29 March 2024].

Figure 1.3 displays annual energy transition investment levels since 2004. Until 2013, most energy transition investments were focused on renewable energy sources. Since 2014, the sorts of investments made have become more diverse, with investment quantities nearly tripling by 2023. In 2023 global investment in the energy transition reached a record $1.8 trillion, up 17% from the previous year (Figure 1.3, Bloomberg). Climate tech companies raised $84 billion in private and public equity in 2023, a 34% reduction year on year for the second straight year; nevertheless, loan issuance for energy transition goals grew 4% to $824 billion in 2023. In 2023, sales of eight types of sustainable debt instruments totalled just over $1.3 trillion, a 15% decrease from the previous year (Figure 1.4, Bloomberg), which could be attributed to central banks' increased interest rate action to lower inflation rates in response to pandemic-caused supply chain inflation.

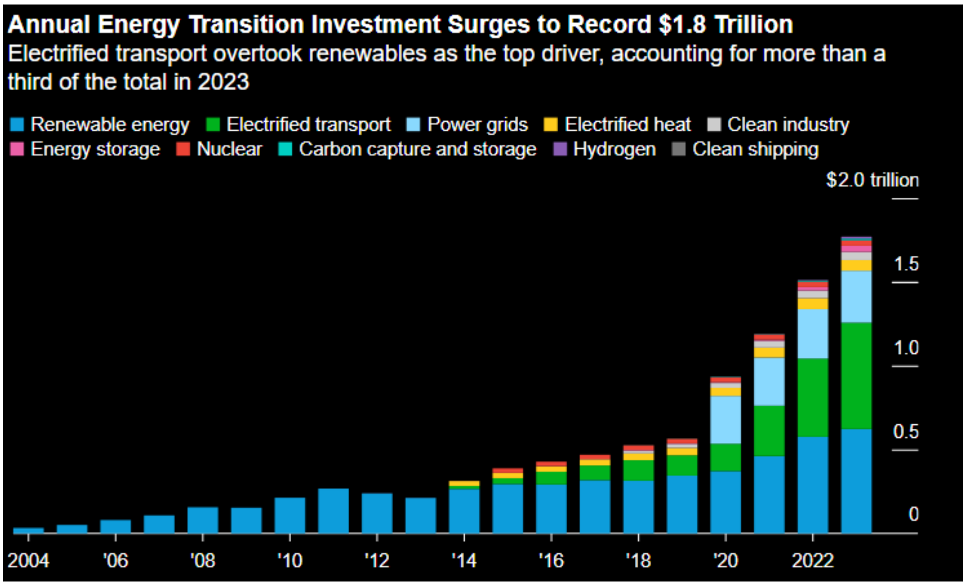

Figure 1.3 Annual energy transition investment
Source: Bloomberg terminal, accessed on 29th of March 2024

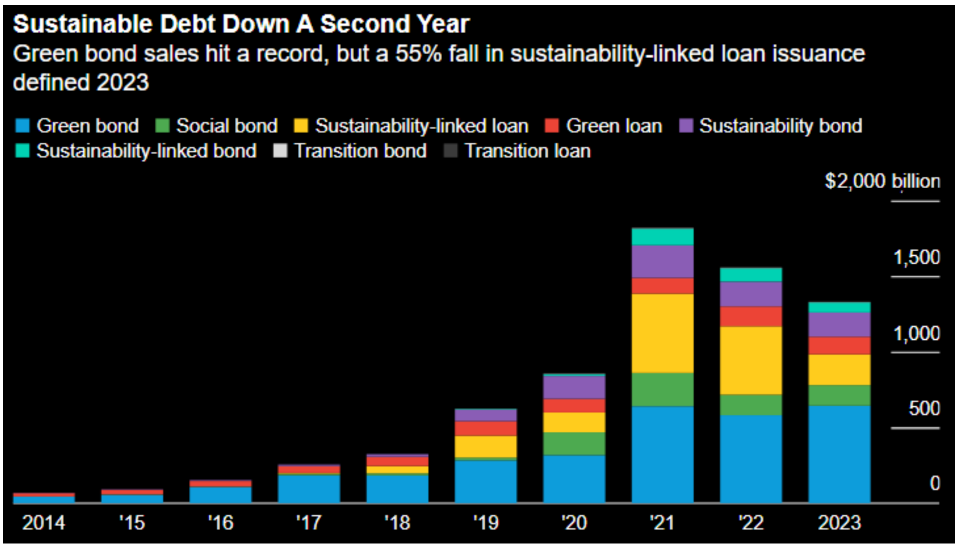

Figure 1.4 Sustainable Debt issuance
Source: Bloomberg terminal accessed on 29th of March 2024

Although energy transition investments have been steadily increasing, reaching a record high in 2023, sustainable debt issuance has been declining since 2021 (Figure 1.4). Kyle Harrison, head of sustainability research at BNEF (Bloomberg New Energy Finance), stated that this is due to growing concerns about greenwashing, combined with the macroeconomic climate of rising interest rates since 2020. [7] With the increasing popularity if the sustainable and green bond markets there has always been greenwashing concerns. Greenwashing is a marketing tactic used by businesses to increase the appeal of their products to environmentally sensitive customers. It entails promoting products as ecologically beneficial while engaging in harmful environmental practices, therefore misleading consumers about the company's commitment to solving climate change. [8] Overall trend of the sustainable and green financing is positive with growing demand for it.

Sustainable financial products

Financial institutions are increasingly addressing stakeholder expectations for sustainability by articulating a corporate purpose and explaining how it will influence decision-making processes.

Financial institutions are building their green portfolios thanks to a number of financial products designed for both issuers and investors. These securities include green bonds, green loans, sustainable bonds, sustainability-linked bonds, sustainability-linked loans, blue bonds, and social bonds. [1] Green bonds, which have been in existence since the European Investment Bank (EIB) issued the Climate Awareness Bond in 2007 and the World Bank's inaugural green bond in 2008, are used to fund environmental or climate-related projects in a variety of sectors, including renewable energy, energy efficiency, and clean transportation. Sustainability bonds cover a larger range of ecological and social initiatives connected with the United Nations Sustainable Development Goals (SDGs), whereas sustainability-linked bonds offer variable financing conditions based on the issuer's achievement of predefined sustainability targets. Green loans are used to fund only ecologically beneficial initiatives, and borrowers are expected to report on the use of revenues and associated environmental implications on a regular basis. Similarly, sustainability-linked loans link interest rates to sustainability performance metrics, rewarding borrowers to accomplish their sustainability goals. Blue bonds, which are established by governments or development banks, attempt to finance marine and ocean-related endeavours, as demonstrated by the Seychelles Blue Bond's assistance for marine conservation and blue economy growth. Social bonds, which focus on social programs like food security and disaster aid, are gaining popularity among investors, as indicated by the issue of EU SURE social bonds in October 2020. [1] Despite differences in scope and form, these financial instruments collectively help to advance sustainability goals in the environmental, social, and economic domains.

7 Bloomberg (2022) *Sustainable debt issuance Dips as scrutiny increases*, *BloombergNEF*. Available at: https://about.bnef.com/blog/sustainable-debt-issuance-dips-as-scrutiny-increases/ [Accessed: 29 March 2024].
8 BBC (2021) *What is greenwashing and how can you spot it? BBC Newsround*. Available at: https://www.bbc.co.uk/newsround/58465027 [Accessed: 29 March 2024].

Conclusion

Sustainable financing, especially those related to climate change risk, are now critical for financial institutions. A growing number of stakeholders are vocally calling for change, and pressure from regulations and policies is also growing. Recently, banks are trying to match their corporate mission statements with sustainability activities, which has forced them to deal with the actual implementation of ESG solutions across their entire business and disclose them on their reports. While some banks might decide to lead the way on ESG problems to beat rivals and regulators, others might decide to follow shortly. However, it is crucial that every bank develop a well-thought-out long-term plan since, ESG issues will always exist.