MAKING FINANCE SERVE THE ENERGY TRANSITION

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"Those with economic power continue to justify the current global system in which speculation and the pursuit of financial gain prevail, disregarding everything around it and the effects on human dignity and the environment." Pope Francis, Laudato Si, § 56

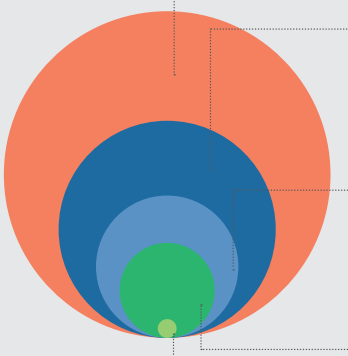
Key energy transition data

- It is estimated that **US$6,200 billion per year** will be needed worldwide through to 2030, two thirds of it for developing countries, for the adaptation of their production, consumption and transportation systems[1].
- **Between US$140 billion and US$300 billion per year** will be needed through to 2030, and US$280 to US$500 per year through to 2050[2], to help vulnerable countries deal with the consequences of climate change.

Key financial sector data

- The total amount outstanding on derivatives[3] worldwide by market value is **US$15,000 billion**[4], with only 10% of it relating to the real economy[5].
- Some 70% of the business of European banks – over **US$33,300 billion** – is devoted to trading activity, which does not serve the real economy or society[6]. Less than 30% of it serves non-financial corporations and household customers.

COMPARISON BETWEEN THE ESTIMATED REQUIREMENTS OF THE ECOLOGICAL AND ENERGY TRANSITION, AND FINANCIAL MARKETS ACTIVITIES AND WORLDWIDE WEALTH



US$75,500 BILLION:
World GDP in 2016

US$33,300 BILLION:
Amounts applied by European banks to trading activities that do not serve the economy or society

US$ 15,000 BILLION:
Worldwide gross amounts outstanding on derivatives

US$6,200 BILLION:
Annual requirement for the adaptation of production, consumption, transport and other systems

US$300 BILLION:
Annual requirement for helping vulnerable countries to deal with the consequences of climate change

DESPITE ITS CENTRAL ECONOMIC ROLE, THE FINANCIAL SYSTEM HAS ONLY LIMITED ABILITY TO FUND THE ENERGY TRANSITION

What involvement does the world of finance have in funding the energy transition?

In order to implement the Paris COP21 climate agreement, and to attain the UN 2030 Agenda Sustainable Development Goals (SDGs), many economic, financial and political initiatives have been put into action to raise and channel the necessary funding.

On the whole, however, the developed economies have opted to rely overwhelmingly on the private sector, particularly for funding these commitments. This is partly because of the need to transform the processes, activities and structure of the entities that make it up. But it is also partly because the funding cannot be raised in most developed countries to sustain ambitious public policies, due to the austerity policies in place in many of them.

So we therefore need both to radically transform the business model of companies and financial institutions, and also to completely refocus the financial markets and redirect investment towards the challenges of mitigating climate change and adapting to it.

Several policies are currently being implemented that aim to redirect funding toward the energy transition. For instance, within the next few months the European Commission is to put forward a European Sustainable Finance Strategy[7]. The recommendations made to date cover the transparency and reporting requirements for finance industry entities (incorporating sustainability into the internal decision making criteria), introducing a classifi-

WHAT IS FINANCE?

The finance industry is a group of entities that create and channel money – that they receive from participants in the economy (households, companies, governments, local authorities, international financial markets, and others) – and that they then direct to other participants who want that money. It is where the decisions are made on the required return and the terms of lending. Banks play a crucial role in the economy by administering payment methods and by granting loans. However, these activities that are so crucial for the economy today represent only a small part of the business of banks compared to their trading activities, which are dangerous and of little value to society and the economy. European banks devote over 70% of their balance sheets to trading activities. Under 10% of debt securities issued, under 10% of OTC derivatives and under 5% of foreign exchange transactions relate to companies in the non-financial economy.
(See http://www.finance-watch.org/hot-topics/understanding-finance/920-understanding-finance-1)

cation of financial assets and regulatory incentives (for example, bonuses or disincentives). Recommendations will also be made on the issue of carbon pricing. The Financial Stability Board is considering such criteria with a more global scope[8].
In France, Article 173 of the 2015 Ecology and Energy Transition Law imposes the requirement to disclose climate-related risk to investors. To date, this is the most stringent accountability requirement worldwide.

As regards business and industry, some large private institutions have started to divest out of fossil fuels[9], and many public and private entities are issuing green bonds. These include businesses, banks and financial institutions, regions and cities, as well as the *Agence Française de Développement* development agency. Between 2005 and 2016, almost 3,500 climate-related bonds were issued worldwide by some 800 issuers. In 2017, the total value of green bonds in issue stood at US$895 billion, although under one quarter were properly labelled "green"[10].

What are the limitations of the current financial system as regards funding the energy transition?

Overall, existing initiatives are going in the right direction, but they are mostly tweaks to existing mechanisms rather than radical changes. Because of that, they are of limited value in funding the energy transition, and some initiatives even carry substantial risk.

1- The risk of a glass ceiling for energy transition funding

The investment required to achieve the energy transition is for the most part infrastructure investment with a long pay-back period. This is of limited appeal so long as there are high-risk speculative products on the market with very high yields over the very short term, often yielding over 10%. As long as investors have a choice between a risky but very profitable (and perhaps harmful) investment, such as a tracker fund or a derivative, and a lower yielding and longer term investment, it is hard to see how there could be a large enough increase in funding for the energy transition.
Besides, the Basel Committee international banking regulations[11], do not provide for loans to be distinguished by the carbon footprint of the project being funded. The level of equity required to cover these risks does not take this criterion into consideration. There are therefore no regulatory incentives to help redirect funding towards the energy transition[12].

2- Few guarantees on the proper use of funding

The accountability requirements on green bonds are rather lax. Where they exist at all, they are voluntary in nature, such as the Green Bonds Principles. Nothing really prevents an institution that has raise funds by this means from carrying out activities that might have little – or even no – connection with the energy transition. These financial instruments are currently of value only to those persons who believe in the need for investing in the energy transition, and to a few others who may be interested on reputational grounds.

3- The risk of speculation in green products

Once the green bond market reaches a significant size, and assuming the financial markets are still operating in the same way, investors are bound to wonder about hedging risks. And, on the financial markets today, this essential hedging is delivered via derivatives. This practice is the root of speculative malpractice and is potentially harmful because it is completely possible to purchase a derivative without having transactions to hedge. That is how speculative bubbles form.

4- Lack of diversity in the banking system

What is more, the banking system is dominated by large banks which, because of their structure and funding methods, favour large-scale energy projects. Breaking away from an energy system based on fossil fuels by its very nature involves running projects of a variety of sizes – large installation such as wind farms, but also a whole host of renewable energies projects on a local

> **" OVERALL, EXISTING INITIATIVES ARE GOING IN THE RIGHT DIRECTION, BUT THEY ARE MOSTLY TWEAKS TO EXISTING MECHANISMS RATHER THAN RADICAL CHANGES."**

1 New Climate Economy, http://newclimateeconomy.report/2014/wp-content/uploads/sites/2/2014/08/NCE-Global-Report_web.pdf
2 http://www.unep.org/adaptationgapreport/2016
3 Derivatives can be used to hedge against risks on financial transactions involving particular assets, but there is no requirement to own the hedged asset and there can be several derivatives over the same asset.
4 Gross value measures the size of the sums invested in the derivatives market. The notional value of derivatives (that is to say the total value all contracts) stands at the astronomic sum of 483,000 billion dollars, which gives an idea of the sums that would be at stake on this market in the event of a crisis.
5 Bank of International Settlements, mid 2016, https://www.bis.org/statistics/d5_1.pdf
6 European Central Bank figures, 2016, http://www.ecb.europa.eu/stats/money_credit_banking/credit_institutions_and_money_market_funds/html/index.en.html
7 On the institutional front, this is considered to form part of the wide-ranging Capital Markets Union plan, which was launched by Juncker Commission in 2015 to develop non-bank finance for the economy. See https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en
8 By means of a working group: Task force on Climate-related Financial Disclosures. See https://www.fsb-tcfd.org/
9 « Depuis 2015 et la COP21, 745 institutions à tr»Since 2015 and COP21, 745 institutions worldwide, managing $5,500 billion in assets, have decided to divest out of fossil energies» http://www.novethic.fr/isr-et-rse/actualite-de-lisr/isr-rse/les-institutions-catholiques-desinvestissent-massivement-les-energies-fossiles-144867.html
10 The Climate Bonds Initiative distinguishes bonds that are «labelled» as green (assessed as meeting the criteria) and «aligned» bonds, which have climate-related objectives and which are not labelled, see http://www.climatebonds.net/files/files/CBI-SotM_2017-Bonds%26ClimateChange.pdf
As a reminder, the total value of the worldwide bond market was estimated at US$100,000 billion in 2014 against 10,000 in 1990. This means it has increased in size 2.7 times faster than worldwide GDP
11 As regards financial stability, the Basel Committee rules require the banks to maintain a certain level of equity to back their lending commitments. Their commitments are weighted mainly according to the risk of non-repayment. These weightings are calculated by banks themselves, which might cause to them underestimate the most risky commitments. Because these weightings are done by the banks in-house, it is hard for the regulators to keep a close eye on the risks taken and then make comparisons. This makes it difficult to oversee the systemic risk inherent in an interconnected banking system.
12 See this briefing (in French) from la Fabrique Ecologique (p12), L'Epargne au Service de la Transition Energétique, novembre 2015, http://docs.wixstatic.com/ugd/ba2e19_6d6c18a46a4f44eca6aa222a734d2fe1.pdf

and/or regional scale. The challenges of the energy transition call for a very wide range of bank and financing options that would also include local banks, and mutual and cooperative entities.

5- Little room for manoeuver politically

Governments, particularly in developed countries, are deeply indebted to the financial markets[13], and the financial markets favour austerity policies. This prevents governments committing large-scale investment to the energy transition and conducting ambitious policies and/or offering incentives because bringing the finance industry on board leaves them little room for manoeuver.

This internalization of austerity by political leaders is also largely due to the fact that public sector officials, politicians, bankers and major corporate bosses share a common culture. They have the same initial education and training, and very similar career paths. In France, 34% of the "*Inspecteurs des Finances*", the financial regulators, have worked for or are working for the banking industry, and almost half of them will end up back in the public sector. Bank regulation bodies also have a number of former bankers[14] on their staff. Thus governments, particularly those of developed countries, are not in a position, or do not have the will, to bring in the strict regulation needed to radically restructure the financial system and make it serve society and the common good, of which the change to cleaner energy and safeguarding the environment are examples.

If we are to have energy policies robust enough to cope with the challenges that face mankind, the financial system needs to be radically reformed, both in terms of what it does and of how it is supervised. The growth in green funding mechanisms and resources can only have a limited impact as long as the current short termism prevails.

HOW TO BOOST FUNDING FOR THE ENERGY TRANSITION

Three measures could be taken now to ensure the success of the existing initiatives:

- **Regulate green bonds** to track the funds and increase accountability as to their use, as well as introducing safeguards against the risk of speculative malpractice;
- **Price carbon emissions** at an ambitious level to discourage investment in the carbon economy,
- **Reform the equity capital requirements of banks** by increasing the ratio of equity that banks must hold as backing for fossil energy loans to discourage them, while at the same time decreasing the ratio of equity for loans in support of the energy transition, to encourage them.

Radical reforms to make finance sustainable and ensure that it serves the energy transition

To break with the short-termist bias of current finance and to promote investment that is for the public good, such as the energy transition the following measures are required:

- Make the financial system safer by segregating banks from non-bank institutions, and increasing their equity capital ratios. These measures would reduce the opportunities and attraction of speculation for investors, thereby increasing the attractiveness of investments that are for the public good.
- Diversify the financial sector by promoting the rise of small financial structures that are more likely to fund projects of a local dimension, founded on renewable energies, and the Short Circuit and circular economies.
- Regulate the business of non-bank financial entities. This would help channel investment towards combatting climate change.
- Include some representatives of civil society on the regulatory bodies and change the composition of the decision-making bodies of the banks themselves, so as to reflect the public interest better.
- Make it easier for governments to fund incentive measures for green investment – such as the low carbon economy and circular economies, and risk management mechanisms such as insurance and guarantees. This can be achieved in particular by taxing capital inflows and outflows, and by taxing financial transactions. It could also be achieved by allowing central banks to lend to States.

13 For instance, French public debt stood at 98% of GDP in 2016

14 https://www.franceinter.fr/economie/les-hauts-fonctionnaires-dans-les-pantoufles-de-la-finance
See also Corporate Europe Observatory study: https://corporateeurope.org/sites/default/files/attachments/open_door_for_forces_of_finance_report.pdf

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