PERSPECTIVES

Achieving Net Zero
The crucial role of the financial sector

June 2023

How can the financial sector contribute to the decarbonisation of the global economy?

Achieving net-zero emissions by 2050, as laid out in the Paris Agreement, hinges on the involvement of the financial sector. Indeed, this sector bears considerable responsibility for greenhouse gas emissions: its own operations combined with its financing activities account for approximately 60% of total emissions globally. *(UN Environment report)* And whilst emissions from the direct operations of financial institutions are not inconsequential, those associated with their investing, lending and underwriting activities are, on average, over 700 times higher. *(CDP – Disclosing financial institutions report)*

However, thanks to its position as an indispensable source of financing, the financial sector possesses considerable power to steer investments towards sustainable and low-carbon projects, which can greatly contribute to reducing greenhouse gas emissions. For example, in 2022, the world's 60 largest banks provided $6.73 trillion in fossil fuel financing. *(Banking on climate chaos report)* Redirecting these investments towards renewable energy and other sustainable projects could have a transformative effect on global emissions.

The Paris Agreement explicitly calls for financial institutions to make their finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development. By financing initiatives like renewable energy, sustainable transportation and green buildings, the financial sector can expedite the transition to a low-carbon economy and make a significant impact in the fight against climate change.

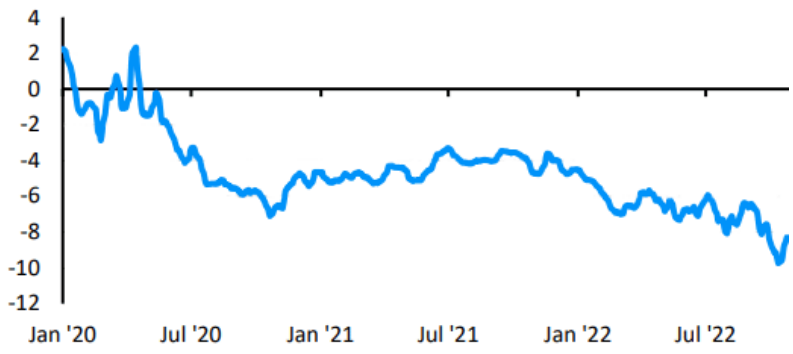
To achieve sustainable development goals, including limiting the global temperature rise to 1.5 degrees Celsius, it is imperative to mobilise sufficient resources. According to the UN, this requires an increase of $5 trillion in global gross investment by 2030. *(UN Financing Climate Action)*

The rising concern about climate change has spurred many investors to seek sustainable financing instruments, including green bonds, green loans and sustainability-linked loans. Such financial tools aim to fund projects that promote directly or indirectly sustainable development and minimise the impact of human activity on the environment.

The popularity of these sustainable financing instruments has grown significantly in recent years as investors seek to align their portfolios with their values. Global sustainable bond issues could reach EUR 880bn in 2023, an increase of 30% over 2022 *(CACIB ESG Fixed Income Research - Bloomberg)*, of which 59% could be dedicated to green bonds.

The acceleration of green bond issues is occurring within the context of an expanding investor base and, as a result, it benefits from increased liquidity. This trend has been particularly evident in the post-Covid era, where sustained decreases in spreads, rather than occasional fluctuations, have been observed. Consequently, it seems that green and sustainable bond issues are outperforming conventional bonds and facing less selling pressure. By blending profitability goals with environmental considerations, green bonds have become a highly advantageous option for companies.

Option-adjusted spread between green bonds and conventional bonds denominated in euros, in basis points

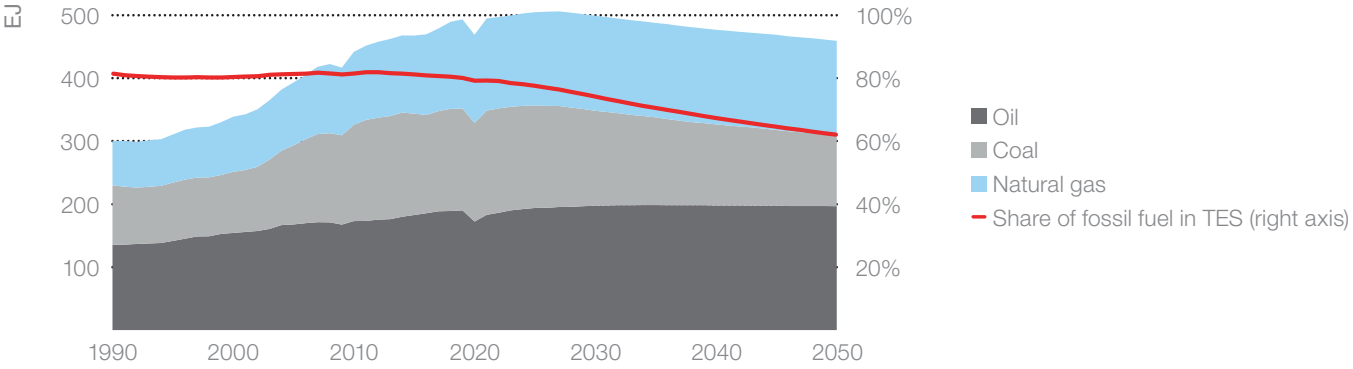


Source: "Barclays Research and J.P. Morgan Asset Management

For decades, changes in gross domestic product have correlated strongly with the consumption of energy and other natural resources. However, the latest projections *(from the 2022 STEPS report)* indicate that significant changes are on the horizon, with fossil fuel use predicted to decrease to less than 75% of total energy supply by 2030 and to just over 60% by 2050. As a result, some economies that have traditionally relied on hydrocarbons, such as those in the GCC region, are now exploring the use of renewable energy resources to diversify their energy mix. The success of early adopters in the GCC region, dating back to the early 2000s, has shown the economic feasibility of renewable energy, and recent photovoltaic (PV) projects in the area have demonstrated some of the world's lowest levelised cost of electricity (LCOE), such as the 600 MW Shuaibah solar project, which announced an electricity cost of only 1.04 cents per kilowatt-hour.

In many cases, renewable energy is proving to be more profitable than oil. But some hydrocarbon-reliant economies still have substantial oil reserves, and we may naturally wonder if that will affect their motivation to accelerate the transition towards renewable energy sources. Will they prioritise the long-term benefits of renewable energy, or will their continued dependence on oil pose challenges to their efforts for sustainability?

Development of the share of fossil fuels in the total energy supply



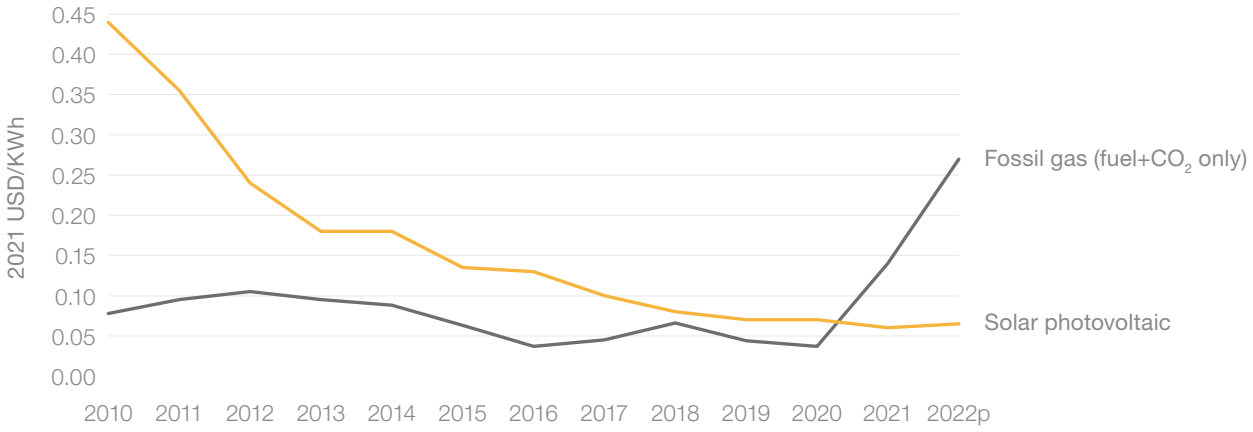
Source: IEA World Energy Outlook 2022

As the cost of renewable energy continues to fall year after year, and the cost of fossil fuel continues to rise, the energy market is facing an unprecedented shift in demand in favour of sustainable energy. In Europe, between January and May 2022, solar PV and wind generation alone likely avoided the import of fossil fuels in the order of USD 50 billion – predominantly of natural gas. But the extent of the fossil fuel price crisis, which started in 2022, has overshadowed the fact that without renewables the situation for consumers, economies and the environment would be much worse.

The role of the financial sector in addressing the issue of climate change cannot be overstated. By investing in mitigation finance, economic benefits can be realised, such as reducing the cost of climate change in the long term, improving energy security and creating new economic opportunities. Mitigation finance is critical in achieving the long-term goal of limiting global warming to a maximum of 1.5 degrees Celsius above pre-industrial levels. However, the equally important adaptation finance must not be ignored. Adaptation finance focuses on addressing the effects of climate change that are inevitable, or indeed, already here, such as rising sea levels and more frequent and severe weather events. The challenge of mitigation and adaptation finance is particularly pronounced in southern countries, which are especially vulnerable to the adverse effects of climate change. The financial sector must confront these dual challenges head-on to ensure a sustainable future for all.

To achieve this goal, the sector must overcome the obstacles that make it difficult to access sustainable finance. Incorporating sustainability into investment decision-making is complicated by a lack of clear and consistent standards that are urgently needed to ensure financing options are aligned with the principles of sustainability, allowing investors and borrowers to support sustainable projects while earning a return on investment or offsetting costs.

The weighted average LCOE of utility scale solar PV compared to fuel and CO_2 cost only for fossil gas in Europe, 2010-2022



Source: IRENA – Power Generation costs 2021

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