Regional financial cooperation and climate change finance

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28 November 2024

Climate change refers to enduring variations in temperatures and weather patterns. Such variations can be natural, due to shifts in the sun's activity or large volcanic eruptions. But since the 1800s, human activities have been the main source of climate change, primarily due to the burning of fossil fuels like coal, oil and gas. Climate change is set to have a significant adverse economic impact on many countries, with a large number of lower income countries being particularly at risk. The macrofinancial impacts of climate change can cause a balance-of-payments or financial crisis that can materialize through a number of channels that emanate both from physical climate risks and transition risks. Physical risks as the term implies relate to the tangible impacts of climate change such as the damage caused by extreme weather events like hurricanes and floods. Transition risks are those associated with the pace and extent at which economic agents manage and adapt to the internal and external pace of change to reduce greenhouse gas emissions and transition to renewable energy.

A detailed analysis of the macrofinancial impacts of climate change is provided by Volz, et al. (2020) while a useful summary is contained in Volz (2021). Various channels—covering both physical and transition risks—are identified following the IMF's classification of macroeconomic risks and contingent liabilities. Macroeconomic risks related to natural disasters and extreme weather include risks of a disruption of economic activity, which may adversely affect tax income and other public revenues and increase social transfer payments; changes to commodity prices that could affect revenue or increase spending via fossil fuel or food subsidies; effects on inflation and interest rates through supply or demand shocks; and exchange rate effects. Contingent liabilities include the physical damage of public assets and public spending for humanitarian crisis and public health emergency, among others.

The institutions that comprise the GFSN should be capable of analyzing and responding to these risks. They should develop the policy frameworks and lending instruments to manage climate-related crises. Volz (2022) proposes the following measures to help climate-proof the operations of the IMF and RFAs: 1) mainstream systematic and transparent assessments of climate-related financial risks in all operations; 2) introduce consistent, systematic, and universal appraisal and treatment of physical climate risks and transition risks in surveillance and monitoring for all countries; 3) ensure that all policy recommendations are aligned with the Paris climate goals; 4) advance disclosure of climate-related financial risks and promote sustainable finance and investment practices; 5) support member countries in mainstreaming climate risk analysis in public financial management; 6) support climate-vulnerable countries in dealing with debt sustainability problems; 7) develop lending instruments for climate emergency financing; and 8) in the case of the IMF, explore options to use special drawing rights (SDRs) to support climate vulnerable countries.

Of particular interest among the proposals of Volz (2022) is item [4] since it relates to Article 2.1(c) commitment of the Paris Agreement. Recent studies indicate that the world will need $10 trillion annually between 2030 and 2050 to avoid the worst impacts of climate change. The Intergovernmental Panel on Climate Change (IPCC) clarifies that "there is sufficient global capital to close the global investment gaps … but there are barriers to redirecting capital to climate action." The challenge, then, is not necessarily raising additional finance for climate change mitigation and adaptation, but how to align all the world's capital towards climate action. Article 2.1(c) of the international Paris Agreement on climate change aims to do just that by

“making finance flows consistent with a pathway towards low greenhouse gas (GHG) emissions and climate-resilient development.”

Regional financial cooperation has an important role in this context. Box 5 describes an approach for regional cooperation in Asia in order to direct financial flows to climate-resilient infrastructure. Many of the proposals and recommendations have been implemented. In March 2023 ADB began implementing a regional technical assistance program titled “Strengthening Ecosystem for Sustainable Finance in ASEAN+3” to develop local currency bond markets and sustainable finance ecosystems, with the goal of strengthening the role of capital markets in mobilizing public and private funds to create positive environmental and social impacts in the region. Meanwhile, the AsianBondsOnline portal has a section on sustainable bonds. The companion publication Asia Bond Monitor, which examines the outlook, risks, and policy options for East Asian local currency bond markets, also has a section on sustainable bonds. The CGIF, a trust fund of the ADB and an initiative under ABMI aimed at supporting local currency bonds by enhancing credit, guaranteed Sabana Industrial Real Estate Investment last June 2024. The five-year SGD100 million sustainability-linked bond (SLB) is CGIF’s inaugural guarantee for an SLB and also its first guaranteed bond to be issued under ASEAN Capital Markets Forum’s sustainable finance standards. In 2022, the GSS+ Bonds Initiative for Southeast Asia was launched under the auspices of the ASEAN Catalytic Green Finance Facility. GSS+ bonds are 'use of proceeds' (UoP) bonds and must be linked to projects that have positive environmental outcomes (green bonds), social benefits (social bonds), or a mixture of both (sustainability bonds). The GSS+ Bonds Initiative for Southeast Asia aims to deepen and accelerate the development of sustainable capital markets, catalyze signature GSS+ issuances, and create enabling environments for growth. The target is at least $1 billion worth of GSS+bond issuances by 2025

Promotion of climate related finance is reinforced by two studies focused on Southeast Asia (ADB and GGGI 2022, WEF 2024). WEF (2024) is based on consultations and workshops with key stakeholders from ASEAN or international organizations working in the region. Meanwhile, the ADB and GGGI (2022) is a report on surveys that were conducted from November 2021 to June 2022 across several AMS via an online platform, receiving a total of 314 responses from institutional investors—pension funds, asset management companies, commercial banks, and insurance companies—and 96 responses from underwriters, advisors, and securities issuers. There is a great deal of synergy and complementarity in their findings and recommendations. It is expected that the two studies will benefit other emerging markets and developing economies.

Key findings from the survey of the ADB and GGGI are as follows

- The green bond market in ASEAN has already shown promising signs of growing strongly with the potential to expand further. This is in no small measure due to the regional initiatives like the ASEAN Capital Markets Forum (ACMF) and the ACGFF.

- The majority of investors prefer small transactional investment sizes of USD10 million or less. Larger ticket sizes are preferred by investors in more developed markets such as Singapore. However, the vast majority of underwriters prefer to work on bonds with larger issuance sizes, typically ranging from USD11 million to USD50 million.

- Renewable energy is considered the most promising growth sector in most countries. The majority of respondents agree that renewable energy is one of ASEAN’s most promising industries, both in terms of investment and the issuance of green bonds.

- The lack of distinct advantages over conventional bonds hinders market growth. The majority of investors stated that the lack of clear advantages of green bonds over conventional bonds was a concern shared by all ASEAN members.

- Tax incentives can be the primary mechanism to increase the supply of and demand for green bonds. In addition, clear green definitions developed and/or endorsed by regulators, as well as other policy support from local regulators, are essential for mainstreaming climate finance in ASEAN.

- Portfolio diversification, an improved green image, and the integration of sustainable development goals (SDGs) into investment policies are among the key motivations for investing in green bonds. In addition, investors consider the valuation and pricing of green bonds, credit ratings, and company profiles to be the most important factors when making investments.

- From issuers' point of view, the opportunity to attract new investors and the possibility of lower funding costs are the two most important factors in deciding whether to issue green bonds.

The WEF study focuses on how to ensure that total added costs of issuing labelled bonds[1] cannot surpass the added benefits. This dovetails with the ADB-GGGI survey finding that lack of distinct advantages of green bonds over conventional bonds hinders market growth. One of the recommendations relates to tax incentives to increase demand for labelled bonds. To attain the objective of achieving a net benefit position, the following measures are proposed:

- Early engagement and close alignment between investors and issuers;
- Provision of enabling market environment, including the development of transition plans;
- Clear and applicable regulatory framework, e.g. standards alignment, introduction of levels of "greenness" and standardized post-issuance requirements;
- Organizational preparedness of issuers;
- Knowledge generation, including directed knowledge-sharing, sovereign issuances as first-mover, education support and capacity building;
- Policies aimed at increasing investor demand for labelled bonds through measures like enhanced returns, reduced financial risks, investment mandates, capital requirements, tax incentives and credit ratings; and
- Direct support for issuers, which may include issuance grant schemes and direct issuance support (developing frameworks for issuers).

References

Asian Development Bank and Global Green Growth Institute. 2022. *Survey on Green Bonds and Sustainable Finance in ASEAN: Insights On The Perspectives Of Institutional Investors And Underwriters*. Manila.

[1] Following the definition of the Climate Bonds Initiative (CBI), labelled bonds can be classified into two categories: First, use of proceeds bonds, which require the raised capital only to be used for specific and pre-defined projects, and, second, impact bonds (IB) that are tied to specific environmental, social and governance (ESG) targets, although their proceeds can be used by the issuer for any purpose. The GSS+ bonds is another term for UoP bonds.

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