Beyond ESG

To activate hope, activate capital

Strategist views
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The atmosphere at the end of last month's United Nations Climate Change Conference (COP27) in Egypt was rather sobering. Russia's invasion of Ukraine has forced countries to turn to thermal coal and other fossil fuels to meet their energy needs, likely postponing the transition to a net-zero economy. But COP27 also underscored the need to leverage public policy, regulation, and technological innovation to achieve a climate-secure future.

By now, it has become abundantly clear that supporting climate-related projects around the world at the necessary scale will require vast amounts of capital. The International Energy Agency estimates that the clean-energy transition alone will cost trillions of dollars annually,[1] even without factoring in loss and damage, particularly in developing countries. The breakthrough agreement reached at COP27 to create a fund to help lower-income countries deal with the worst effects of climate change suggests that world leaders are aware of this fact.

But capital from donations and multilateral development banks alone will not be enough. The private sector must step up, too. Thus far, there has been no clear path to unlocking global capital markets' vast potential. There are, however, good reasons to be hopeful.

For starters, governments have made significant progress toward ensuring higher-quality data. In March, the US Securities and Exchange Commission proposed requiring some companies to disclose information relating to the risks they face from climate change, following on the heels of the European Union's comprehensive directive[2] from last year refining their long-established framework. The Chinese Securities Regulatory Commission proposed similar measures a few months later. High-quality climate-risk data from the world's three biggest economic blocs would enable investors to assess sustainable technologies' risk-return tradeoffs.

But while such analytical tools have a crucial role to play, investors also need incentives. This is where carbon pricing and taxes come in. Even though it is a European measure, the EU's recently adopted carbon border adjustment mechanism will likely have a global effect, as countries exporting goods and services to Europe will quickly realize that reducing their carbon footprint is in their own commercial interest. Although the new US Inflation Reduction Act does not impose a carbon tax per se, it does bring America closer to pricing carbon emissions by providing incentives for clean energy and climate-related spending, including carbon capture, utilization, and storage.

These positive developments—the result of cooperation among policymakers, asset owners, and investors—will accelerate the growth of local and global carbon markets. While such markets currently cover less than 25% of global emissions,[3] the Africa Carbon Markets Initiative, launched during COP27, is another breakthrough, as are the national carbon markets rolled out in countries like China and Singapore.

Investors' conversion to the climate cause offers yet another reason for hope. Asset owner coalitions, such as Climate Action 100+, and asset-manager alliances, like the Net Zero Asset Managers initiative, represent almost $70 trillion in assets.[4] And more than 600 investors (including us) representing over $40 trillion in assets signed the Global Investor Statement at COP27, advocating for policies enabling a just transition to a low-carbon economy.

This increase in investor activism reflects a goal that we all share, regardless of nationality or political affiliation: *financial return*. Capitalizing on the growth potential of climate solutions is in the economic interest of all stakeholders, which is why recent efforts to politicize environmental, social, and governance goals have been so counterproductive. Sustainable investing is not about advocating for anyone's values; it is about *creating* value.

The powerful combination of sustainable finance and rapid innovation in climate technologies could expedite the net-zero transition. By financing nuclear, wind, solar, and geothermal power, as well as clean-energy storage technologies such as pumped hydropower and thermal storage, we could make electricity production more sustainable.

Once investors have useful information and adequate incentives, capital markets could be left to do what they do best—allocate capital at scale. But first policymakers must focus on climate solutions' very real commercial opportunities, rather than on specific agendas grounded in anachronistic terminology. The US Department of Labor's recent decision to reverse restrictions that prohibited retirement fiduciaries from considering ESG criteria is a step in the right direction.

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Although the Ukraine war has impeded the transition to a low-carbon economy, it has also highlighted the need for energy and food security. Shutting down an oil or gas pipeline, after all, is much easier than preventing the sun from shining or the wind from blowing. But to build sustainable, resilient systems, countries and companies must invest in energy-efficient infrastructure and sustainable agriculture. To be sure, some of these climate solutions are not economical yet. But over time, with the support of governments and the growing interest of capital markets, green technologies will become scalable and more affordable.

The challenges ahead may seem daunting, but reasons for hope are emerging. Global climate investment is set to exceed $915 billion this year,[6] a 13% increase from the year prior and just shy of $1 trillion. By continuing to activate capital markets, we can allocate resources to where they are most needed, achieve a net-zero economy, and mitigate the worst effects of climate change.

Endnotes

1. Source: International Energy Agency, "Net Zero by 2050" last updated May 2021.
2. Source: European Commission, Corporate Sustainability Reporting Directive.
3. Source: The World Bank. 2022. "State and Trends of Carbon Pricing 2022" (May), World Bank, Washington, DC. Doi: 10.1596/978-1-4648-1895-0. License: Creative Commons Attribution CC BY 3.0 IGO.
4. Sources: Climate Action 100+, The Net Zero Asset Managers initiative.
5. Source: IEA (2021), Greenhouse Gas Emissions from Energy Data Explorer, IEA, Paris.
6. Source: Institute of International Finance, "Green Weekly Insight: Better prospects for climate finance flows", December 15, 2022.

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