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The Climate change and Fossil Fuels (CLIFF) project studies policy challenges surrounding the energy transition

Global finance can phase out fossil fuels: but will they?

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Key Messages

1. **Alignment with the Paris Agreement will require financial institutions to make major changes to how their investments, loans, and spending are implicated in the energy transition.**
2. **Loans by development banks to Southern banks increases their exposure to stranded assets.**
3. **Pension funds leave potential leverage points for pressuring the fossil fuel sector unexplored.**
4. **Philanthropies maintain a status quo incompatible with a 1.5°C future**

Introduction

The 2015 Paris Agreement on Climate Change implicates the financial world in the fight against climate change through Article 2c which commits to "Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development"[1]. Limiting warming to 1.5°C would require leaving 60% of oil and gas reserves and 90% of coal unburned and in the ground[2]. However, globally, finance continues to flow to fossil fuel exploration and expansion, while there is underinvestment in green infrastructure and energy[3]. Given their size and/or influence, major financial intermediaries including development banks, pension funds, and philanthropic foundations will play an important role in determining the success and speed of the energy transition.

1. Alignment with the Paris Agreement will require major changes to current practices of investment, loans, and spending.

Much progress is needed before the financial sector can be considered Paris-compliant. The investment practices, loans, and spending activity of large investors continue to support the fossil fuel sector. The 'Big Three' asset managers (BlackRock, Vanguard, and SSGA) top the list of the largest shareholders in the fossil fuel industry (alongside major government shareholders, such as the government of India and the Kingdom of Saudi Arabia)[4].

Pension funds control $57 trillion globally[5], of which OECD pension funds hold an estimated €238–828 billion in liquid fossil fuel investment[4]. Their total exposure to 'climate-policy-relevant' sectors may be even higher (as much as 40% of equity holdings for European pension funds)[6]. Much of this exposure is indirect, through investment in financial institutions who in turn invest in fossil fuels. Investment- and commercial banks have provided $4.6 trillion to the fossil fuel sector since 2015 in the form of loans and underwriting[7].

Development banks, in comparison to commercial banks, have moved more towards financing renewables. This can be seen in the fall of FF share of World Bank's investment portfolio from 51.8% between 1985-1990 to 15.2% between 2011-2019, while there has been a corresponding rise in renewables[8]. However, this pattern is not seen across other financial intermediaries.

Meanwhile, philanthropies hold around ~$1.5 trillion in assets worldwide[9]—60% of which by the U.S—and act as both grantmakers and investors. Between 2011-2015, U.S. philanthropies spent ~$550 million on climate action, ~$69 million of which on "actions to limit/oppose fossil fuel industry"[10].

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2. Loans by development banks to Southern banks increases their exposure to stranded assets.

As development banks grow their business with southern banks via debt, Southern banks grow and increase their portfolios, which include FF companies. This portfolio increase is associated with an increase in exposure to stranded assets within FF industry. Accumulation of these risky assets will have implications for Southern banks' portfolio quality. Understanding and quantifying the externalities of development banks' debt within Southern financial institutions (i.e., banks, insurers, etc.) becomes important to align development banks' efforts with the SDGs.

3. Pension funds need to consider other tools to accelerate a fossil fuels phaseout

The potential for pension funds to accelerate the fossil fuel phaseout has frequently been understood as a choice between divestment or shareholder engagement to convince fossil fuel companies to reduce emissions. However, both have been inadequate thus far. Beyond just engaging companies, pension funds could engage with the largest shareholders and financiers of fossil fuels (e.g. Blackrock, JP Morgan), in which they also invest. Pensions could introduce climate-friendly mandates into their contracts with asset managers and investment consultants and engage with non-investor financial actors (e.g. index providers, stock exchanges, proxy advisors). Lastly, litigation and increasing climate-friendly investments could also accelerate the energy transition[11].

4. Philanthropies maintain a status quo incompatible with a 1.5°C future

Philanthropies engage civil-society by funding research, think-tanks, policy groups, and have played a leading role in creating initiatives such as the IPCC (1988), UNFCCC (1992), and others[12,13] . In combination with actions from other investors, the result is a climate action narrative that is "U.S. friendly"[12], promotes "clean growth"[14], and by and large prioritises strategies which avoid emission reduction legislation and do not "bring forth a low-carbon regime"[15]. It appears dissonant that philanthropies' grantmaking and investment activities do not accelerate a fossil fuel phaseout, while their public mission statements are calling for Paris-compliant climate action.

5. Conclusions

Financial institutions have the capacity to catalyse the energy transition through their investment practices and advocacy efforts to sway decision makers such as company management and asset managers. It remains to be seen whether their financial and relational influence will be used for climate action or inaction instead. The former will require a shift away from the short-termism and profit maximisation mandates which financial institutions currently operate under.

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