Frequently Asked Questions (FAQs)

Chapter 15: Investment and finance

FAQ 15.1 What's the role of climate finance and the finance sector for a transformation towards a sustainable future?

The Paris Agreement has widened the scope of all financial flows from climate finance only to the full alignment of finance flows with the long-term goals of the Paris Agreement. While climate finance relates historically to the financial support of developed countries to developing countries, the Paris Agreement and its Article 2.1(c) has developed on a new narrative on that goes much beyond traditional flows and relates to all sectors and actors. Finance flows are consistent when the effects are either neutral with or without positive climate co-benefits to climate objectives; or explicitly targeted on climate benefits in adaptation and/or mitigation result areas. Climate-related financial risk is still massively underestimated by financial institutions, financial decision-makers more generally and also among public sector stakeholders limiting the sector's potential of being an enabler of the transition. The private sector has started to recognise climate-related risks and consequently redirect investment flows. Dynamics vary across sectors and regions with the financial sector being an enabler of transitions in only some selected (sub-)sectors and regions. Consistent, credible, timely and forward-looking political leadership remains central to strengthen the financial sector as enabler.

FAQ 15.2 What's the current status of global climate finance and the alignment of global financial flows with the Paris Agreement?

There is no agreed definition of climate finance. The term 'climate finance' is applied to the financial resources devoted to addressing climate change by all public and private actors from global to local scales, including international financial flows to developing countries to assist them in addressing climate change. Total climate finance includes all financial flows whose expected effect aims to reduce net greenhouse gas (GHG) emissions and/or to enhance resilience to the impacts of current and projected climate change. This includes private and public funds, domestic and international flows and expenditures. Tracking of climate finance flows faces limitations, in particular for national climate finance flows.

Progress on the alignment of financial flows with low GHG emissions pathways remains slow. Annual global climate finance flows are on an upward trend since the fifth Assessment Report, according to CPI reaching more than 630 billion USD in 2019/2020, however, growth has likely slowed down and flows remain significantly below needs. This is driven by barriers within and outside the financial sector. More than 90% of financing is allocated to mitigation activities despite the strong economic rationale of adaptation action. Adjusting for higher estimates on current flows for energy efficiency based on IEA data, the dominance of mitigation becomes even stronger. Persistently high levels of both public and private fossil-fuel related financing as well as other misaligned flows continue to be of major concern despite promising recent commitments. Significant progress has been made in the commercial finance sector with regard to the awareness of climate risks resulting from inadequate financial flows and climate action. However, a more consequent investment and policy decision making that enables a rapid redirection of financial flows is needed. Regulatory support as a catalyser is an essential convey of such redirections. Dynamics across sectors and regions vary with some being better positioned to close financing gaps and to benefit from an enabling role of finance in the short-term.

FAQ 15.3 What defines a financing gap, and where are the critically identified gaps?

A financing gap is defined as the difference between current flows and average needs to meet the long term goals of the Paris Agreement. Gaps are driven by various barriers inside (short-termism, information gaps, home bias, limited visibility of future pipelines) and outside (e.g. missing pricing of externalities, missing regulatory frameworks) of the financial sector. Current mitigation financing flows

come in significantly below average needs across all regions and sectors despite the availability of sufficient capital on a global basis. Globally, yearly climate finance flows have to increase by factor between 3 to 6 to meet average annual needs until 2030.

Gaps are in particular concerning for many developing countries with COVID-19 exacerbating the macroeconomic outlook and fiscal space for governments. Also, limited institutional capacity represents a key barrier for many developing countries burdening risk perceptions and access to appropriately priced financing as well as limiting their ability to actively manage the transformation. Existing fundamental inequities in access to finance as well as its terms and conditions, and countries exposure to physical impacts of climate change overall result in a worsening outlook for a global just transition.