

Tackling climate challenges through financial regulation

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Toward intervention frameworks in support of the environmental transition

Policy Brief

Key points:

- Published in October 2024, the United Nations Environment Programme's Emissions Gap Report 2024,^[1] which discusses the gap between projected and needed emissions reductions, shows that rising greenhouse gas emissions are pushing the planet toward a temperature rise of 3.1°C, well above the Paris Agreement's threshold of a 1.5°C rise by 2100. To achieve that goal, the report recommends a 42% reduction in emissions by 2030 and a sixfold increase in investment.
- The cost of inaction on climate change will be higher than that of action. According to the World Meteorological Organization's State of the Climate in Africa 2023 report,^[2] climate change is causing African countries to lose between 2 and 5% of their GDP, with some countries devoting up to 9% of their budget to responding to climate extremes.
- Financial regulation policies now include climate risks in their stability mandate. But this practice remains at a preliminary stage and its role in meeting the targets of the Paris Agreement is uncertain.
- Regulatory policies must explicitly include financial inclusion, which boosts resilience, in their intervention frameworks.

[1] United Nations Environment Programme, *Emissions Gap Report 2024: No More Hot Air ... Please! With a Massive Gap Between Rhetoric and Reality, Countries Draft New Climate Commitments* (Nairobi: UNEP, 2024). <https://doi.org/10.59117/20.500.11822/46404>.

[2] World Meteorological Organization, *State of the Climate in Africa 2023*, September 2, 2024. <https://wmo.int/publication-series/state-of-climate-africa-2023>.

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Two schools of thought for understanding sustainability issues

Adopted in 2015, the Paris Agreement aims to limit global warming to 1.5°C by 2100. It reflects the need for action to reduce greenhouse gas emissions and to adapt to the consequences of climate disruptions. One key action lever is to decarbonize the economy, by channeling investment toward low-carbon and resilient activities. To achieve this, financial regulation deploys norms and standards – often originated from voluntary initiatives that can be integrated into regulatory frameworks – based on so-called single and double materiality approaches, which highlight the political fragmentation of sustainability standards.

Single materiality focuses on risks: it assesses the potential loss of value to investors posed by climate risks. Although essential, this approach is limited to fully grasp the implications of these risks due to the uncertainties and technical, methodological, and conceptual challenges in assessing environmental and social impacts. Double materiality can overcome these limitations by considering not only how the environment impacts the company, but also at how the company impacts the environment and society.

Navigating between the integration of climate risks and alignment issues in financial regulation

Several approaches can be considered for making regulatory and financial policy choices more climate-friendly. The most widely adopted are micro- or macro-prudential policies, which are at the heart of the stability mandates of financial regulators. Macro-prudential policy enhances the resilience of the financial system as a whole, while micro-prudential policy focuses on the robustness of individual financial institutions. These two complementary policies are essential for preventing the buildup of risks within the financial system and for ensuring its stability. In the context of climate change, risks fall into two categories: physical risks, such as extreme weather events that result in losses for economic actors; and transition risks, related to the long-term economic consequences of adapting economies to a low-carbon model. The methods used by central banks and financial regulators to evaluate an entity's capacity to face these risks are based on scenario assessments, such as those of the Intergovernmental Panel on Climate Change (IPCC), and stress tests.

The *Agence française de développement* (AFD) (French Development Agency) supports its partners in implementing micro-prudential policies, while also addressing macro-prudential issues. This support is targeted, proportionate, and tailored to specific contexts and economic structures (concentration, integration of value chains, maturity of financial systems, etc.). For instance, its partnership with Banxico (Mexico's central bank) and the Economic Commission for Latin America and the Caribbean (ECLAC) aims to develop tools for modeling and analyzing climate scenarios in the region. By combining models for evaluating physical and transition risks – like the GEMMES model developed by AFD^[3] – these tools allow for a simultaneous examination of both types of risk. They thereby help to address the macroeconomic stability issues affecting

Mexico, such as balance of payments tensions and foreign reserves management. Since the early 2020s, an increasing number of tools have been implemented to enable more forward-looking risk analyses.

Although necessary for ensuring the stability of the financial system, these policies must be complemented by non-prudential policies to more effectively steer financial flows toward the environmental transition. Taxonomies play an important role as environmental “compasses” by classifying economic activities based on their environmental impact. AFD, in collaboration with the World Bank, helped Indonesia to green its financial system by publishing a green taxonomy in early 2022. However, this approach can be limited by a lack of enforcement or incentive mechanisms, its binary and static nature, and insufficient transparency and monitoring.

Alignment frameworks have recently been developed to shift the focus onto action, moving from “what to do” to “how to do it.” These frameworks support the development of transition plans and decarbonization goals for companies. Ensuring the credibility and feasibility of these strategies requires identifying their dependencies on climate policies – both domestic and external – as well as on technologies. These transition plans are only meaningful when informed and guided by national strategies, such as the “long-term development strategies” or “national adaptation plans” for which the AFD is advancing the work, as exemplified by the Facility 2050 grant program.^[4] The harmonization of these different alignment frameworks at the national and international levels is key in order to ensure their interoperability and facilitate capital flows. A number of initiatives, such as the G20 Sustainable Finance Platform, are attempting to address this issue.

More prescriptive, but also more extensive, green monetary policies or credit allocation policies – typical of planned economies – can deliver stronger interventions and direct credit toward specific sectors and activities to support industrial and planning policies. Such policies can be justified within the stability mandates of central banks, which must ensure price stability and fight the inflation that may result from climate shocks.

Maintaining and strengthening financial inclusion

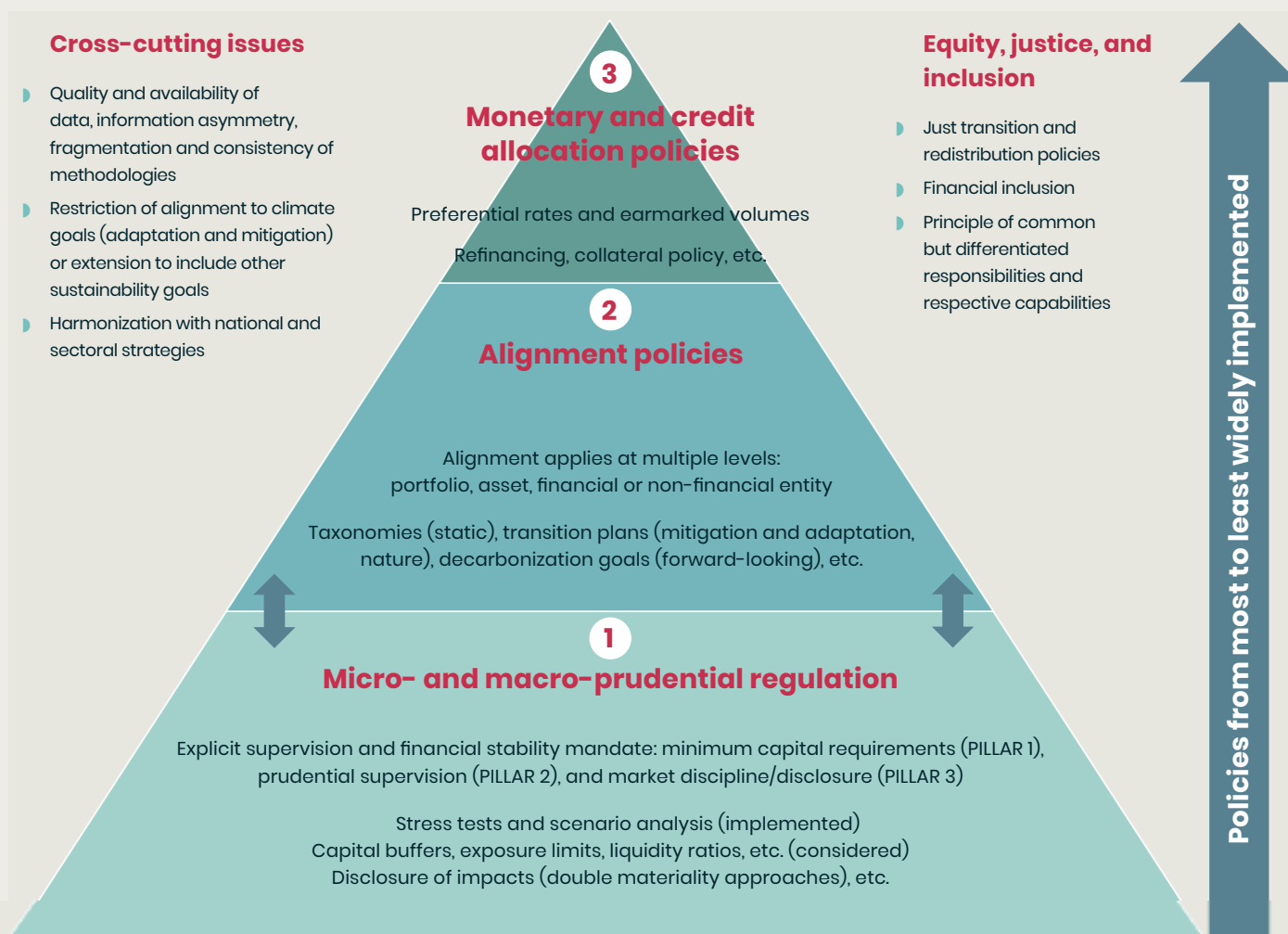
In response to climate risks, banks and investors may reduce their exposure to vulnerable entities – such as households, SMEs, or the agricultural sector – that face weakened solvency, thus limiting the latter's access to risk management and transfer solutions. Likewise, access to insurance might become more costly, and certain companies – particularly those with high carbon footprint – could find themselves excluded from financial services, without support for their transition. Additionally, the high costs associated with the disclosure of sustainability information required by regulatory frameworks, as along with the misalignment between some of these frameworks and national pathways, may further hinder the mobilization of external financing in the context of global financial markets. AFD is strongly committed to fostering inclusion and supports the Alliance for Financial Inclusion,^[5] an international network of central banks, finance ministries, and financial regulators. This initiative aims to support

[3] See: <https://www.afd.fr/en/page-programme-de-recherche/gemmes-new-modelling-tool-incorporates-energy-transition>.

[4] See: <https://www.afd.fr/en/2050-facility>.

[5] Charlotte Fauquembergue, “Tackling Climate Change and Financial Inclusion Will Require Cross-Cutting Solutions,” *Afi*, October 28, 2024.

Figure 1 - Climate-friendly financial policy options



Source: authors.

the most vulnerable regions in need of assistance. The funded activities primarily focus on adaptation, insurance, climate-related financial risks, and disaster management, concentrating on three key pillars: knowledge, practice, and impact.

To mitigate the identified issues, it is important that regulatory frameworks and the support provided to regulators by donors like AFD contribute to:

- Making **sustainability information and data accessible and public** in order to reduce information asymmetry and speed up transitions, including adaptation;
- Strengthening the **interoperability** of national regulatory frameworks at the international level, particularly in terms of alignment, with the right level of flexibility and giving **priority to national trajectories and plans**;
- Promoting and adopting “**double materiality**” approaches to assess impacts on vulnerable groups and on the environment – a key factor of resilience – based on the criteria of “scale, scope, and irremediable character”;
- Integrating “**just transition**” elements and social and environmental criteria into the “**do no harm**” principle of alignment frameworks, including transition plans or taxonomies;
- Making **de-risking mechanisms** (or mixes of public-private funding and other regulatory measures such

as refinancing lines and guarantees) conditional on inclusion goals or the financing of common goods;

- Actively supporting **financial inclusion** beyond a strictly climate perspective.

Despite the proliferation of voluntary and regulatory initiatives over the past decade following the signing of the Paris Agreement, much work remains to be done, particularly to integrate social and environmental costs and identify co-benefits, in order to make more informed investment decisions, which are often restricted by a narrow cost-benefit logic. There is still confusion around the role of risk-based approaches in the transition, as well as around the clear allocation of responsibilities between financial sectors, regulators, central banks, and policy makers.

The recent trend to require the disclosure of transition plans must not become a simple compliance task without credibility. Rather, it is an opportunity to shed light on dependencies with regard to climate policies and inter- and intra-sectoral synergies. The aim afterward is to support the implementation of these identified dependencies. Finally, a persistent blind spot of transition plans is insufficient consideration of adaptation and resilience issues, which must be addressed.

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Themes

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