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SUSTAINABLE FINANCE MONITOR

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Editor's Note

Dear Reader,

As we write, **Russia's war in Ukraine** is nearing its second month. At the IIF, our thoughts are with all those affected by this terrible human tragedy. The tremendous disruption from the war has also laid bare the stark geopolitical tensions and practical challenges of a rapid shift away from fossil fuels. With few prospects for near-term resolution to the conflict, the implications for multilateral climate action and the ESG agenda are already being felt (see **section 1.1**). Looking forward, one positive legacy that could emerge from the horrors of war is a galvanization of political will for a [shift into the highest possible gear on the Net Zero transition](#), worldwide.

Dire news and new scientific analysis from the IPCC last month attest to the fact that climate change remains the greatest risk for the prosperity of humankind — and a primary threat to security. Last month saw simultaneous super-extreme heat waves above the North and South poles, where temperatures reached [50 to 70 degrees Fahrenheit warmer than seasonal averages](#), the latest sign that the risks of dangerous climate change are manifesting. The **IPCC's recent report on mitigation** (see **section 1.2**), considered to be the global scientific body's 'final warning' on how to stop dangerous climate change, is clear testament to what is at stake. The IPCC's key conclusion — that the world has **thirty months** to reverse a century-long trend of ever-increasing carbon emissions — sets a herculean challenge for public and private sectors alike.

The implications for the global financial system are clear: capital must be mobilized for decarbonization at massive scale, with investments in climate mitigation needing to increase up to six times current levels. Scaling up [blended finance solutions](#)—which can be game-changing by de-risking investments in areas like

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climate-resilient infrastructure—will be critical to ensure that emerging markets are able to manage the transition while also balancing sustainable development priorities.

However, it is becoming increasingly clear that success will require [collective action across public and private sectors, international governance bodies, NGOs — and a full spectrum of global actors](#). Financial institutions need clear policy frameworks for the low-carbon transition which target supply and demand side actions across the economy. Today’s fragile geopolitical context, soaring prices, and potential for social unrest could well be a further constraint on the political will to act with urgency. While pushback on near-term costs and concern about the [risks of ‘greenflation’](#) will continue, the spectre of climate-related conflict should also catalyze a radical shift in thinking and spur greater ambition for the energy transition – and the essential role of finance in supporting it. Recent developments – including the release of the SEC’s proposed rule on climate disclosures (**see section 1.4**), and the ISSB’s draft of a new baseline sustainability disclosure standard – are an important step in the right direction, with a clear focus on transition plans and the necessary metrics to help investors evaluate the transition potential of a firm or sector. However, continued efforts will be needed to address the interlinked challenges of **integrity and alignment** in policy frameworks – on which the IIF has developed a [‘Roadmap’ for public-private collaboration in 2022](#).

On the occasion of the 2022 Spring Meetings of the IMF and World Bank, we are pleased to release this special edition of the Sustainable Finance Monitor in a new format, which we will release going forward on a quarterly basis. We’ve expanded our **Big Picture** segment to include additional thought leadership and analytical pieces – and have introduced a new **‘Member Perspective’** section (**see section 1.3**), with an inaugural contribution this quarter from our IIF SFWG Chair, Judson Berkey, Managing Director and Group Head Engagement and Regulatory Strategy, Chief Sustainability Office at UBS. Our **Global Policy and Regulatory Update** as always looks across key developments in major jurisdictions in the last quarter, while also bringing together news on frameworks, initiatives, and the latest scientific research (**see section 2**). For additional information, our [Global Regulatory Update](#) covers broader developments in financial regulation and policy. Please don’t hesitate to [reach out](#) if you have any questions on our work on sustainable finance at the IIF or our [in-person and hybrid events](#)—including our upcoming [Sustainable Finance Roundtable](#) on April 21, featuring the ECB’s **Irene Heemskerk**, **Hiroshi Matano** of the World Bank’s MIGA, and UK Climate Champion **Nigel Topping**. Please contact Ellen Ehrnrooth (eehrnrooth@iif.com) for further details on virtual or in-person participation.

We hope that you find this document useful, and welcome your comments and reactions on the new format. We will look forward to sharing our Q3 issue in July, and to seeing many of you at our upcoming events.

- Sonja Gibbs, Managing Director and Head of Sustainable Finance, IIF

1. THE BIG PICTURE

1.1 Rising Geopolitical Risks: Implications for Climate, Net Zero, and the ESG Agenda¹

Russia's invasion of Ukraine—even beyond the human tragedy—has resulted in significant economic and financial market disruption, with major implications for the energy transition, climate policy, and the global ESG agenda. Western countries have responded by implementing broad-ranging sanctions on Russia's economy (see [here](#) for in-depth IIF coverage). Recognizing that the conflict is at an acute stage and rapidly evolving, this piece assesses the impacts and implications of the recent rise in geopolitical risks from two perspectives: i) the energy transition, and ii) the sustainable finance and ESG agenda.

1. Implications for Energy Transition and Climate Change

Aggressive [action to advance the Net Zero transition](#) could emerge as a national security priority in some jurisdictions in support of energy independence, but it won't be a smooth ride. We see two implications for the energy transition in such regions—notably the EU: i) near-term reconsideration of timelines for reductions in fossil fuels to make up for the shortfall due to supply shocks, and ii) rapid recalibration of energy policies to build greater resilience and energy independence.

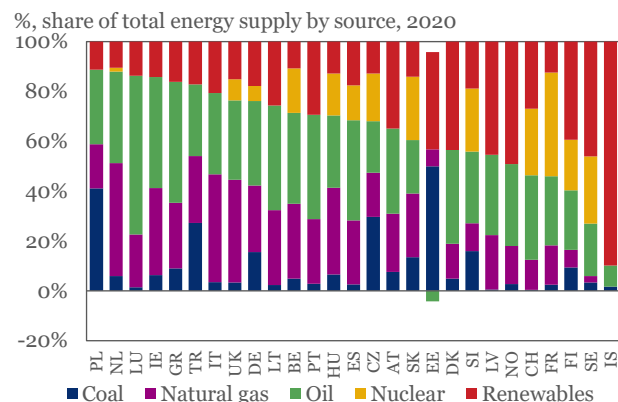
Near-Term Reactions – Filling the Energy Gap

Strong reliance on fossil fuels in the EU energy mix has constrained the potential for decisive collective action on imports. Europe is dependent on Russia for [roughly one-third of its natural gas, and one quarter of its oil imports](#), and supply chain disruptions and significant increases in energy prices are already [disrupting Europe's economy](#). While the use of imported fossil fuels varies significantly across the EU (see Figure 1), major economies including [Germany](#) are significantly reliant – especially on natural gas imports (Figure 2). Considering that natural gas is more difficult to replace across the economy, it is likely that a [complete halt to natural gas imports](#) will be very hard to achieve, and much more difficult than for other fossil fuels, such as oil and coal, as currently being [discussed](#).

In the medium term, the EU energy mix could become *higher* carbon on the basis of fuel switching, as efforts to limit gas imports take hold. In some key European countries – such as Germany – a lack of domestic gas resources, and limitations to expansion of capacity in neighbouring countries, may lead to increased reliance on fuels that are more readily available, including coal. Gas-to-coal switching in Europe in 2021, largely motivated by high gas prices, [led to a 16% increase in coal-fired electricity emissions](#). A prolonged conflict in Ukraine and further reductions in fossil fuel imports from Russia could lead to even more reliance on coal over gas. Carbon emissions prices in the EU ETS – which dropped from a peak of near €100/t in late February to a low of €58/t on March 7 – have rebounded to near €80/t. However, it is unclear if EU allowance (EUA) prices will rise enough to render coal uneconomic compared to gas in the short-term when factoring in both fuel and emissions costs.

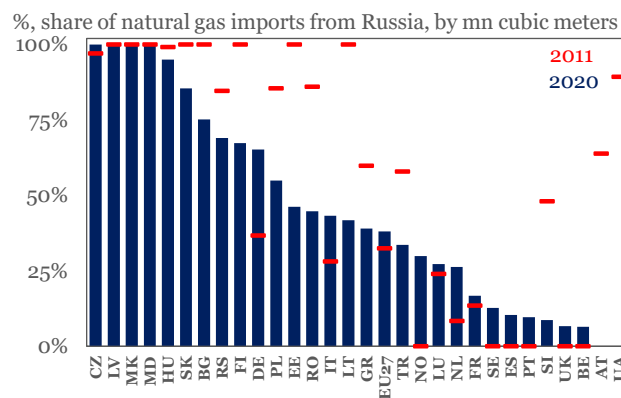
¹ Author: Jeremy McDaniels, Senior Advisor, Sustainable Finance; with inputs from Emre Tiftik, Director, Sustainability Research, and Paul Della Guardia, Financial Economist.

Figure 1: Fossil Fuels in the EU Energy Mix



Source: IEA, IIF; negative values imply exports on a net basis

Figure 2: reliance on Russian natural gas imports in Europe.



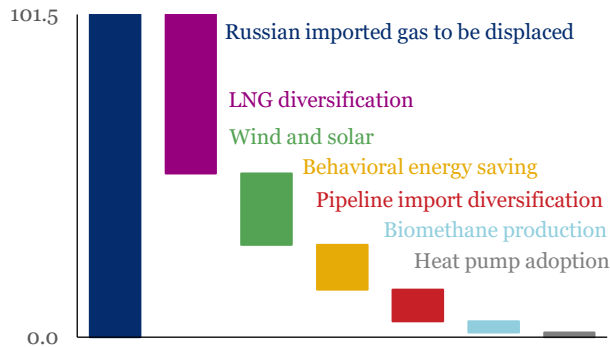
Source: Eurostat, IIF

Energy Policy – a Push for Green Energy Sovereignty

Politicians in several EU member states, at the EU level, in the UK and the US have made statements calling for reduction in exposures to Russian energy on the basis of energy security priorities, and as a strategy to further isolate Russia economically. The EU’s payments to Russia for fossil fuels, including oil and gas, amount to [as much as \\$1 billion per day](#). EC President von der Leyen has written that “We are determined to limit Putin’s capacity to finance his atrocious war (...) The EU must get rid of its dependency on fossil fuels,” while Germany’s finance minister has called for a transition to renewable electricity – “[the energy of freedom](#)” – by 2035. On March 8, the EU announced a new policy package entitled [REPowerEU](#), which outlines a plan to achieve independence from Russian fossil fuels “well before” 2030. The plan aims to reduce demand for Russian gas by 101.5bcm – over 60% – in 2022 alone (Figure 3), with proposed measures to diversify gas supplies, increase sources of renewable gas, and replace gas in power and heat generation. While intentions are clear, uncertainties abound – including whether the proposed near-term reduction measures are feasible beyond 2022, and the reliability of options to diversify supply. It is important to note that the 50bcm offset target for replacement from other sources equates to [roughly 10% of the entire global market](#), which could impact other gas importers, including in Asia (Figure 4). Emerging economies in Asia reliant on LNG for their gas supplies could turn to [cheaper alternatives](#) such as coal if higher EU demand for LNG drives prices to unaffordable levels.

Figure 3: REPowerEU seeks to slash EU reliance on Russian gas imports with immediate impact—in 2022

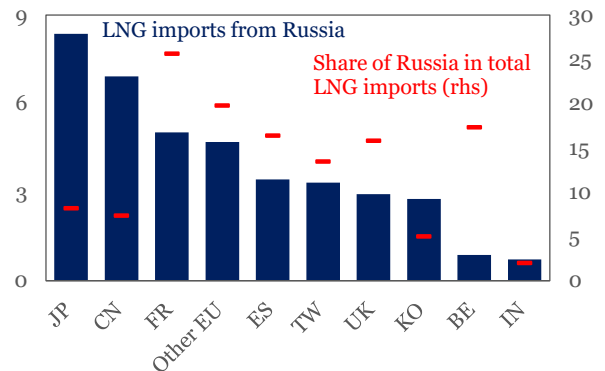
bcm*, EC REPowerEU plan on Russian gas replacement in 2022



Source: European Commission; *billion cubic meters

Figure 4: Europe is an important liquefied natural gas export market for Russia, albeit less so than Asia.

billion cubic meters, Russian LNG exports, 2020



Source: BP Statistical Review of World Energy, IIF

Avoiding Carbon Lock-in: Lessons from COVID-19

Global efforts to “build back better” in the wake of the COVID-19 pandemic faltered in 2021, as CO2 emissions reached new record highs. Analysis suggests that few countries managed to fully seize the “green opportunity” presented by the pandemic, with only [6% of total spending](#) (\$860bn) allocated to areas that could lead to emissions reductions. In fact, allocation of stimulus funding to green sectors in response to the COVID-19 pandemic was [significantly lower than in the wake of the financial crisis](#), when 16% of such support was directed at emissions cuts. According to the [IEA](#), CO2 emissions rose to their highest level in history in 2021, rebounding strongly as the global economy emerged from COVID-19 crisis. This ‘economic restart’ has been fueled heavily by coal use, notably in emerging economies. Despite [record growth in renewable energy implementation](#) in 2021, installations still fell short of [levels needed to achieve Net Zero goals](#), which Bloomberg NEF estimates at over \$2 trillion between 2022-25.

Expansion of renewable energy capacity and enhancements of energy efficiency are the primary channels that governments can pursue to reduce fossil fuel imports – substitution with domestic resources could lead to costly lock-in effects. New policies to diversify energy mixes and reorient trade can enhance independence while also positively contributing to decarbonization goals. From a purely economic standpoint, large-scale investments in clean energy – while having high up-front costs – can lead to major savings while also boosting energy security. Analysts estimate that the cost of meeting the EU’s 2030 energy targets is approximately [€360b per year, on par with the cost of importing fossil fuels](#). Perhaps more importantly, investments in renewable technologies – as opposed to spending on commodities which are prone to both market and geopolitical volatility – will over time support more stable energy prices, provided that adequate investments in energy storage and other low-carbon baseload power can be delivered.

However, in many jurisdictions, near-term substitution appears to be taking precedence – which may lead to investments which expand high-carbon energy infrastructure. Already, major economies have sought to enact measures to address near-term fossil fuels short-falls, with the U.S., Japan, and other IEA members announcing decisions to release [strategic petroleum reserves](#). Some governments including the

[UK](#), have indicated plans to increase domestic fossil fuel production—alongside efforts to accelerate deployment of renewables—in an effort to ensure supply security. Several factors will likely affect the degree to which the Ukraine conflict drives production increases or opening of new reserves in Western countries, including the duration of the [high price environment](#) and [supply chain issues](#).

Considering the lengthy lead times (3-5 years) associated with bringing new fossil fuel reserves to market, **it is unclear to what extent efforts to expand fossil fuel production will actually enhance energy security in the near term.** In many jurisdictions, the quickest and most cost-effective steps to reduce demand for fossil fuels will be through enhancements in energy efficiency, particularly in heating systems. Increasing the deployment of low-carbon heating systems (such as the implementation of [electric heat pumps to replace gas boilers](#)) has been identified as a priority in the REPowerEU plan, which sets a target of doubling deployment rates from 2m to 4m per year. Delivering on this goal will require an array of other interventions, including ending subsidies for domestic gas boilers, retrofitting existing buildings, and changes in retail electricity pricing policies.

Global Climate Diplomacy – Can Necessary Progress at COP27 be Achieved?

Heightened challenges for global coordination in the wake of the Ukraine conflict could significantly impede the multilateral response to climate change. [Agreements at COP26](#) to reduce fossil fuel use – tenuous at their inception due to last-minute amendments introduced by China and India – may prove to be even more fragile if political agreement among key countries becomes more difficult to achieve in the wake of the Ukraine conflict. Inability to deliver progress at COP27, especially on 2030 GHG reduction targets for nationally determined contributions (NDCs), would be dire – and potentially render goals of limiting global warming to 1.5c impossible.

Mature market governments now have an opportunity to leverage the ‘wartime’ mentality invoked for rapid economic decarbonization. Less political acceptance of high levels of exposure to the fossil energy/military complex of autocratic states could influence a paradigm shift in the rate of integration of energy, security, and climate policies. [Stronger alliances](#) among the world’s major economies to develop manufacturing bases for low-carbon technologies and source underlying resources will be needed to face the headwinds of a “changing geopolitics of clean energy” – including China’s strategic investments in developing economies rich in resources relevant for the clean energy transition. More broadly, the impact of the Ukraine crisis on [consumer prices, inflation and growth prospects](#), particularly in major EU economies, may serve as a litmus test for social acceptance of the changing cost structures of the low-carbon transition.

However, strengthening military resilience could come at the expense of climate resilience. Increases in defense expenditure could lead to [fossil fuel use by defense forces](#), while diverting resources away from investments in climate mitigation and adaptation, including investments in nature conservation and restoration, which the [IPCC WGIII report](#) highlights as critical for hopes of limiting climate damages.

2. Implications for ESG and Sustainable Finance

There is a contentious debate underway in the financial press on whether ESG funds’ holdings in Russian companies—and the subsequent uneven response across the investment community—means that sustainable investment is not delivering on its core premise of ‘doing well by doing good.’ Here, we focus on

a few nuances of this debate that may shed light on financial institutions' near-term responses and longer-term strategies.

The Resurgence of Divestment as a Moral Imperative

The widespread withdrawal of capital from Russia's economy — with the aim of leveraging pressure on the Putin regime — is one of the largest collective actions ever taken on ESG priorities (even if not communicated as such). As of April 1, [over 600 major companies and financial institutions](#) have withdrawn from business activities in Russia (including via divestment from Russian companies), suspended business operations, reduced their activities, or scaled back operations. However, there are open questions about where the ultimate impact of divestment from Russian companies may lead, especially in terms of carbon emissions. Large-scale divestment from Russia's high-carbon sectors is leading to downward price pressure that could influence the direction of the conflict; over time, this will affect the cost of capital for these firms. However, if the Ukraine conflict leads to a protracted division in the global economy, an increasingly bifurcated global energy sector could lead to large-scale transfers of financed emissions from the balance sheets of regulated financial institutions to non-bank entities or state-owned enterprises. A prolonged conflict could thus increase the gap between Net-Zero aligned and non-aligned market actors, exacerbating the risk of ['carbon arbitrage.'](#)

Pricing 'Regime Risk'

It is challenging for ESG corporate and sovereign ratings to accurately incorporate the risk of action by autocratic and authoritarian regimes. The majority of global or emerging market ESG funds have been constructed on a best-in-class approach, utilizing a range of third-party ESG ratings. Before Russia's invasion of Ukraine, analysis by Bloomberg suggests that [300 ESG funds held \\$8.3bn in Russian assets](#), out of a total of 4800 funds. These funds, primarily sustainable emerging market equity strategies, had an average [exposure to Russia of 1.8%](#), roughly 2/3 less than the average in the EM segment. Recent developments have raised the question of how much a firm's rating should be affected by the sustainability characteristics of the government in the jurisdiction that it operates. Some ESG ratings providers have moved in this direction, including MSCI, which has [downgraded Russia's sovereign ESG rating](#) from B to CCC, its lowest level. Other companies, such as Sustainalytics, have indicated that they intend to review ESG ratings processes in response to the Ukraine conflict.

Few elements of ESG ratings can serve as useful proxies for 'regime risk': These include controversy scores, which consider issues such as anti-competitive behaviour, business ethics, corruption, human rights abuses, or breaches of environmental safeguards, vary significantly in their construction and scope. Multiple initiatives are seeking to develop more robust benchmarks for performance or exposure to specific sustainability priorities, such as the WBA [Corporate Human Rights Benchmark](#), which considers allegations of controversies in addition to specific events. However, the backward-looking nature of controversy assessment, a lack of consistency in criteria, and divergence in data sources may affect the usefulness of such scores in evaluating "regime risk." For example, imagine a planned investment in a high-carbon company with a strong transition strategy – but located in a jurisdiction where regime change could impact the firm's capacity to achieve its transition goals. Such an investment might require an ex-ante judgement on regime risk to overlay the actual sustainability characteristics of the firm – which could be strong from an emissions reductions perspective. In such cases, detailed analysis would be required to determine the degree to which a particular jurisdiction's government may affect corporate behavior, or

constrain the potential positive impacts of a firm’s activities. Ultimately, investors’ evaluation of the materiality of political risks (such as military aggression) may need to be considered as a subjective choice, weighing trade-offs with other investment objectives – such as facilitating decarbonization.

Preparing for Disruptive Transition

Looking forward, it is increasingly evident that a world that cannot decarbonize quickly enough will face higher risks of economic disruption, challenges for key global governance fora and resource-based conflicts. Given these growing risks, the financial sector will need to further develop strategies to maximize the potential for positive impact under uncertain conditions. In this context, effective risk assessment will necessitate a wholesale reconsideration of which jurisdictions, sectors, and types of financial assets may pose risks from a strategic and reputational perspective.

Financial institutions should expect increasing scrutiny of political risk assessment in sustainable investment strategies from clients, and broad civil society. Greater clarity on the construction and intended financial and non-financial goals of ESG investment products can help, as can stronger internal policies regarding investments in countries with questionable governance. Reputational risks will continue to mount if greenwashing is perceived where a fund’s non-financial characteristics deviate from consumers’ expectations. The media blowback regarding ESG funds’ holding in Russian firms reaffirm the critical importance of clearly indicating how ESG products may [support social or ethical priorities](#), or whether the ESG component of a fund stems from the use of benchmarks or screening tools designed support risk management. Finally, systematic and ongoing analysis will be required to improve the capacity of investors to fully assess and price political risk.

1.2 A Final Warning: Summary of the IPCC’s 2022 WGIII report on the Mitigation of Climate Change²

The IPCC released its third and final report of its 2022 reporting cycle on April 4, completing its sixth comprehensive review of the state of global climate science. Following the [WGI report](#) focused on the state of the global climate, and the [WGII report](#) focused on adaptation, the WGIII report addresses **mitigation**, providing an economy-wide assessment of progress to date, and what actions will be needed to limit the risk of dangerous climate change. Running to nearly 3000 pages, the [Full Report](#) is accompanied by a [Technical Summary](#) and a shorter [Summary for Policymakers](#) – which was subject to intense political negotiation.

Key Takeaways from the IPCC WGIII Report

- Emissions must peak no later than 2025 – and then reduce below 50% of 2019 levels by 2030 – if a 1.5c warming goal is to be achieved. In other words, the world has thirty months in which to reverse the century-long trend of increasing emissions.
- A 1.5c warming pathway can be achieved – necessary technologies and tools are available, and in many areas, are more economic than higher carbon alternatives.
- Decarbonization of the global energy system is a primary priority, through the electrification of as many sectors – including transport.

² Author: Jeremy McDaniels, Senior Advisor, Sustainable Finance.

- There is no room in a 1.5c carbon budget for additional investments in new fossil fuel infrastructure – which would lock in emissions.
- Demand-side changes – including in lifestyle choices, such as diets and consumer preferences – will be critical alongside measures in the energy system.
- Nature conservation and restoration can provide up to 1/3rd of the most cost-effective carbon emissions reductions, including through efforts to stop deforestation.
- The use of CO2 removal (CDR) technology is likely to be ‘unavoidable’ to ensure that a 1.5c warming limit is not exceeded, especially in later decades.
- Finance flows for climate mitigation will need to increase between three to six times this decade if warming is to be limited to 1.5°C.

1. The state of play: ‘Now or Never’ for global climate action

The goal of limiting global warming to 1.5c – agreed by scientists to be the limit of ‘safe’ levels – will be impossible to achieve unless emissions peak no later than 2025. Put simply, the world has thirty months left in which to reverse a centennial trend of increasing carbon emissions. If this cannot be achieved, irreversible climate impacts will manifest, bringing extreme weather, disruptions to the global economy, threats to human life and safety, and cascading effects on natural capital and biodiversity. While temporarily overshooting a 1.5c limit is now ‘almost inevitable,’ temperatures could lower to 1.5c by 2100 if necessary measures are implemented.

However, current policies are not enough to avoid the risks of dangerous climate change. NDCs announced prior to COP26 suggest that global GHG emissions will continue to increase towards 2030, making a 1.5c pathway impossible, and ‘strongly increasing’ of limiting warming to 2c. Under the ‘current policies’ scenario developed by the IPCC, warming may rise to as much as 3.5c by 2100 – fully into the realm of a ‘hot house world’ scenario as envisioned by the NGFS. While recent national pledges on net zero emissions cover over [75% of global emissions](#), a lack of detail on near-term reductions – including by 2030 – calls into question whether or not such goals will be achievable if emissions cuts are delayed.

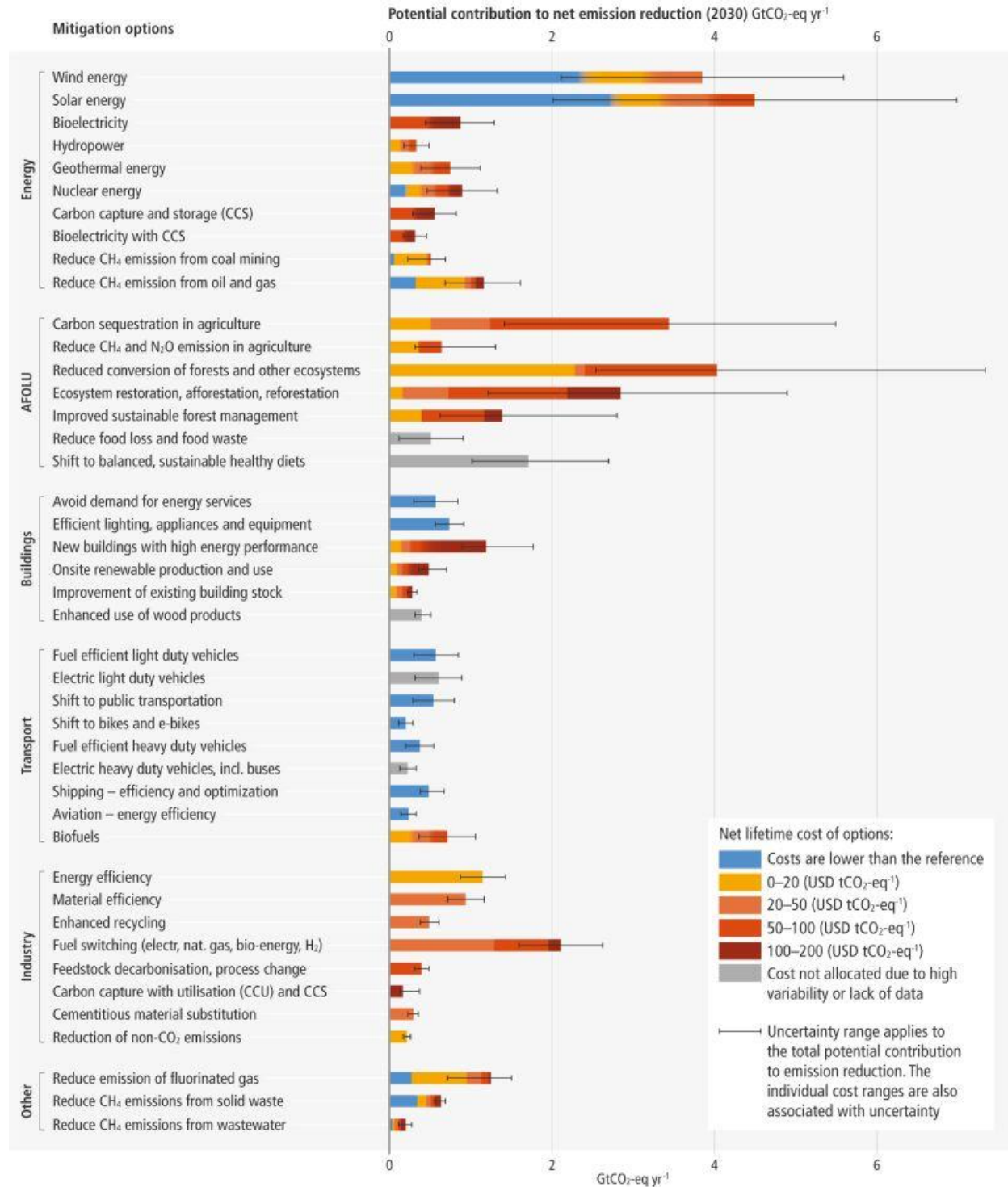
2. What needs to be done

Achieving 1.5c by delivering rapid transformation to Net Zero is still possible, but only just. While the IPCC finds that the 1.5c goal technically feasible, it acknowledges that the pace of economic and institutional change necessary to achieve this transformation would have no precedent in history. **Figure 5** (facing page) provides an overview of the IPCC’s mapping of decarbonization potential across the global economy.

Energy systems: The IPCC is unequivocal in its message that limiting global warming can only be achieved through “rapid and deep reductions” in the energy systems CO2 and GHG emissions. A “substantial reduction in overall fossil fuel use, minimal use of unabated fossil fuels, and use of CCS in the remaining fossil system” is the critical first step towards this goal, alongside widespread electrification, the use of new sustainable biofuels and low-emissions hydrogen, energy conservation and efficiency, and greater integration across the energy system. Looking forward, the IPCC is unequivocal in concluding that there is no room in the 1.5c carbon budget for investments in new fossil fuel infrastructure. Existing and planned fossil fuel projects, if built, will lock in future emissions at levels leading to dangerous climate change. The implications for the global financial sector are clear – if governments deliver the necessary policies to meet the 1.5c goal, the crystallization of transition risks could pose trillions in losses on stranded assets.

Figure 5: Mapping Global Decarbonization Potential

Many options available now in all sectors are estimated to offer substantial potential to reduce net emissions by 2030. Relative potentials and costs will vary across countries and in the longer term compared to 2030.



Source: IPCC WGIII Report

Demand-side changes: A notable development in the WGIII report is the inclusion of analysis of the socio-economic aspects of mitigation. Changes in consumer behavior and lifestyles could reduce emissions by between 40-70% by 2050, through changes in diets, reductions in air travel, the use of zero-carbon ‘last-mile’ transport (such as bicycling), and enhancements in domestic energy efficiency.

Nature conservation: The IPCC highlight the essential need to reduce deforestation, considering that actions to conserve forests and restore degraded landscapes are by far the most cost-effective and efficient means to sequester carbon from the atmosphere. The IPCC concludes that with adequate financing, nature-based solutions could provide up to 1/3rd of the most effective carbon emissions reductions. Critically, efforts to scale-up nature-based solutions will need to be carefully managed to avoid unintended consequences or perverse incentives, such as biomass plantations. To guard against this, the IPCC highlights the importance of indigenous stewardship conservation practices.

CDR: The IPCC considers it ‘almost inevitable’ that carbon removal technologies– such as carbon-capture and storage (CCS) and direct air capture (DAC) – will be needed to ensure that a 1.5c warming limit is not exceeded. However, such technologies cannot take the place of widespread reductions in fossil fuel use, and should only be reserved for application in the hardest to abate sectors. The IPCC’s recognition that climate mitigation will require both emissions reductions and CDR is a notable development, attesting to the urgency of the challenge.

3. How to pay for it

The IPCC concludes that the global financial system is still significantly underdelivering on investments needed to achieve a 1.5c future – even when these investments make sound economic sense. Finance flows for climate mitigation will need to increase between three to six times this decade if warming is to be limited to 1.5°C. Blended finance vehicles will be critical for delivering this step-change in climate finance flows, especially for emerging markets, which need at least [\\$1tn per year](#) in financing for energy system decarbonization, every year, to 2030. [Public guarantees](#) for low-carbon investment, which the IPCC suggests can have a leverage factor of up to 15 times, are currently underutilized due to the fact that such instruments are not considered within official definitions of overseas development assistance (ODA).

Despite recent progress, finance sector climate action is not yet driving decarbonization – and the scale of climate risk is not being fully accounted for. The IPCC has found “limited evidence” that the increase in commitments on climate action by financial institutions has “directly affected emission reductions.” While recent progress on more coherent disclosure standards (via the work of the ISSB) is positive, the IPCC considers that climate risks are “greatly underestimated” within financial markets, which is constraining rapid capital reallocation.

Despite the staggering sums, stopping dangerous climate change is not costly – especially when compared with the alternative. The IPCC has concluded that the costs of achieving Net Zero emissions by 2050 – under a scenario of rapid reductions – would cost 1 to 2% of global GDP, not factoring in addition benefits such as reduced costs to human health. Looking forward, COP27 is set to be as important – if not even more consequential – than COP26, with countries working through the complex details of near-term emissions reductions.

1.3 Member Perspective

Materiality Matters – Why discussions on sustainability reporting standards may polarize unnecessarily

“It’s one thing to feel that you are on the right path, but it’s another to think that yours is the only path.” Paulo Coelho, The Alchemist

2022 is the year sustainability reporting takes a big step forward. The International Sustainability Standards Board (ISSB) has put forward a climate disclosure exposure draft based on TCFD and hopes to have a final standard recognized by IOSCO by year end. The European Financial Reporting Advisory Group (EFRAG) will turn its current working papers into consultation documents for the technical detail to underpin the European Corporate Sustainability Reporting Directive (CSRD). The US SEC is consulting on climate disclosure rules it hopes to finalize by year end and jurisdictions from Switzerland to New Zealand are doing the same. Finally, the Taskforce on Nature-related Financial Disclosures (TNFD) released a beta framework for nature disclosure aligned with TCFD.



Judson Berkey
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Chair, IIF Sustainable Finance Working Group

However, discussions around the future of sustainability reporting too often bifurcate over one specific topic – materiality. One group views double materiality as the only way to give stakeholders an understanding of a firm’s impact on the environment and society and views anything less than that inadequate to our current needs. The other group views double materiality as too open ended and believes reporting should focus on risks and opportunities that are critical to financial performance or future enterprise value which is critical for investors and shareholders.

I suggest that both views, at least in their dogmatic form, are focusing too much on labels and not enough on the details. In the end one has to measure something in order to report on it. And we know that what gets measured is what gets managed. The act of measurement requires specific metrics or performance indicators. This is where the polarization hopefully turns to alignment and we realize that there may not be such a great different between the two materiality concepts.

Let’s start with climate. The TCFD recommendations were established to “promote more informed investment, credit [or lending], and insurance underwriting decisions”. Thus, the TCFD suggested that firms determine materiality for climate reporting in the same way as for financial reporting. However, the TCFD also made clear in its updated recommendations released in October 2021 that Scope 1, 2 and 3 emissions are to be disclosed independent of materiality. Thus, they are essential part of understanding potential risks and opportunities to future financial performance and necessary to financial decision making. This approach has largely been adopted by the ISSB in its exposure draft.

In Europe, EFRAG has the mandate to develop the European sustainability reporting standards following a double materiality principle. EFRAG has developed extensive working papers to outline its initial proposals on reporting standards. These include Scope 1, 2, and 3 GHG emission disclosures. In the climate working paper EFRAG explicitly notes that “the description of the undertaking’s impacts on climate change

is to a large extent covered by the reporting on Scope 1, 2, and 3 GHG emissions.” Thus, one person’s indicator essential to understand future enterprise value based on different future scenarios is another person’s impact measurement. At the level of metrics it does not seem the difference is so large between different forms of materiality. Other countries are following suit and including Scope 1, 2 and 3 in their proposed national standards.

Let’s now move to the next big area for disclosure – nature. Here work is currently underway to develop reporting standards similar to those for the climate. The TNFD released its “beta” recommendations in March. This included recommendations for disclosures very similar to TCFD while noting that work on metrics and targets is still to come. However, one can already look to existing reporting guidance for what may come out from that work. For example, the ISSB prototype from last year included metrics from the Sustainability Accounting Standards Board (SASB) as a supplement to the basic TCFD requirements. This gave additional sector specific guidance on what is considered material for a given sector. To take one example, in the Agricultural Products sector the SASB metrics include various metrics related to water including water withdrawals, water consumption, and violations of rules, standards and regulations related to water quantity or quality. In the EFRAG working paper on water disclosure, the disclosure requirements include indicators for water withdrawal, water consumption, water discharge, and facilities with an overall certified water management system. Thus, the metrics are again very similar even if the starting point perspectives seem to differ greatly. It is true that the EFRAG proposals also call for qualitative disclosure on positive and adverse impacts and dependencies on water and water-related products and services.

However, I would argue that any firm trying to present a fair and accurate representation of its business strategy and future performance would naturally make such disclosures if they are important. For example, one would have to think that a report by a large food manufacturer or commodity firm that did not address water at all would be viewed as incomplete. Such firms would feel market pressure for more disclosure on the topic particularly as water comes under further stress in certain locations. And when one expands disclosures to include medium- and long-term time frames based on scenarios and the idea of transition plans then one certainly is disclosing on impact. This is already true for climate and I believe will wind up the same for broader nature.

Don Quixote’s squire Sancho Panza tells him in Book 1 that “I sometimes think that all you tell me of knighthood, kingdoms, empires and islands is all windy blather and lies”. I don’t want to make that same statement about those debating materiality concepts. But I do want to say that the differences may be exaggerated and that once we get down to substance the gap may not be that large. That should provide a basis for alignment and convergence of reporting standards.

The work of the ISSB is a critical part of the architecture for mainstreaming sustainability. It also provides a home where work on specific issues or topics, such as the nature work by TNFD, can be absorbed. The ISSB and EFRAG are already cooperating to align their efforts at a technical level. The proposed SEC rules have clearly taken into account what is happening globally. Thus, those debating materiality may only be tilting at windmills, and there is already significant common ground. My hope for the next few years is that we find that the idea of truly international and interoperable sustainability reporting standards was not as quixotic as first thought.

1.4 Policy Focus: Unpacking the SEC’s Proposed Climate Risk Disclosure Rule³

On March 21, the U.S. Securities and Exchange Commission (SEC) released [proposed rule changes](#) that would require supervised institutions to begin disclosing climate-related risks that are “reasonably likely to have a material impact on their business, results of operations, or financial condition.” In a [press release](#), Gary Gensler said the rule will provide investors with “consistent, comparable, and decision-useful information” and provide issuers with “consistent and clear reporting obligations.” In its proposed rule, the SEC acknowledges there is fragmentation in the disclosure sphere given the rise of voluntary third-party disclosure frameworks, leading to “a lack of transparency and standardization.” The SEC cited work from the International Financial Reporting Standards Foundation (IFRS), International Organization of Securities Commissions (IOSCO), the International Sustainability Standards Board (ISSB), and the European Union which indicates there is international agreement on the necessity of consistent disclosure standards.

The SEC’s new proposed climate disclosure framework is based on the **TCFD recommendations**, along with concepts from the GHG Protocol – such as disclosure of scope 1, 2, and 3 emissions. However, the proposed rules do go beyond the TCFD in a number of important areas; for instance, by requiring disclosure on **Net Zero commitments and technical approaches for their achievement** (such as transition plans, and the use of offsets), the SEC rules are likely to lead to greater scrutiny of voluntary commitments and measures to achieve them. While many large internationally active financial institutions are already making such disclosures or have capacity to scale up, others—notably smaller financial firms—will face challenges in meeting the proposed SEC disclosure requirements.

Under the proposed rule, SEC registrants will be required to disclose the following in their registration statements and periodic reports:

- Climate-related risks (over the short-, medium-, and long-term) and their potential or actual material business and strategy impacts;
- Governance and risk management processes related to climate risk, including at the board and management levels;
- How climate-related risks have affected (or will affect) strategy, business models, and outlook;
- Processes for identifying, assessing, and managing climate-related risks and whether those processes are included in overall risk management practices;
- Impacts of climate-related events and transition risks on financial statements (both physical and transition risks);
- Greenhouse gas (GHG) emissions – both Scope 1 and 2; and Scope 3 if material, or if a GHG reduction goal has been set that includes Scope 3 emissions; and
- Information on climate-related goals and transition planning (including Net Zero commitments and transition plans) and the use of any offsets.

Additional takeaways from the proposed rule include:

- Dates of **compliance** with the proposed rule will depend on filer status, though all registrants will have a phase-in period, with an additional phase-in for Scope 3 emissions disclosures along with safe harbor provisions.

³ Author: Michaela Palmer, Policy Associate, Sustainable Finance

- For each of its **Scope 1, 2, and 3 emissions**, the proposed rules would require a registrant to disclose emissions both disaggregated by each constituent greenhouse gas (e.g., by carbon dioxide, methane, nitrous oxide, etc.) and in the aggregate.
- The SEC has chosen not to define “short-,” “medium-,” or “long-term,” so as to leave companies flexibility to pick the **time horizons** that work best in their individual cases.
- **Materiality determinations** are in line with the SEC’s requirements for registration statements and annual reports; companies should consider the magnitude and probability of climate risks over different time horizons.
- The proposed rule poses a question regarding its relationship with forthcoming **ISSB standards**, indicating the SEC’s exploration of the frameworks’ connections – including on topics such as disclosure of **transition plans**.

2. GLOBAL SUSTAINABLE FINANCE UPDATE⁴

2.1 Policy and Regulatory Developments (to April 14, 2021)

Region	Country	Description
Americas	Canada	In its 2022 budget , the Government of Canada has confirmed that it plans to phase in mandatory requirements for climate-related disclosures based on the TCFD framework for banks and insurers, starting in 2024. The Office of the Superintendent of Financial Institutions (OSFI) will conduct a consultation on climate disclosure guidelines in 2022. The government has also indicated that it would move forward with ESG disclosure requirements for federally regulated pension plans.
Americas	Canada	The Senate of Canada is debating a draft “ Climate Aligned Finance Act ” which would introduce significant capital requirement changes for climate-related exposures, including higher risk weights for fossil fuel infrastructure and extraction (particularly new exposures), and a ‘systemic climate risk contribution capital surcharge’ based on facilitated emissions. If passed, the law would mandate OSFI to develop guidelines on fossil fuel-based capital requirements and exercise its powers in a climate-aligned manner, and mandate the Bank of Canada to act in alignment with national climate commitments.
Americas	USA	The Securities and Exchange Commission (SEC) released proposed rule changes that would require supervised institutions to begin disclosing climate-related risks that are “reasonably likely to have a material impact on their business, results of operations, or financial condition.” Further information on the SEC’s consultation is provided in section 1.3. The SEC proposed implementing the “ pay-versus-performance ” disclo-

⁴ Authors: Jeremy McDaniels, Senior Advisor, Sustainable Finance; Michaela Palmer, Policy Associate, Sustainable Finance; Ellen Ehrnrooth, Senior Program Assistant, Global Policy Initiatives. This section draws on the ECOFACT AG [Policy Outlook](#), the world’s leading database on hard and soft law initiatives pertaining to sustainable finance and corporate responsibility. The database covers over 30 topics addressed by regulators, supervisors, and standard setters, in over 50 countries representing more than 85% of global GDP and at the international level. The Policy Outlook monitors both existing and upcoming regulatory initiatives as well as changes in their interpretation. For further information contact policy@ecofact.com

		sure rule of section 953(a) of the Dodd-Frank Act. This rule requires disclosure of “the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions.”
Americas	USA	<p>The acting chairman of the Federal Deposit Insurance Corporation (FDIC) released a statement summarizing the FDIC’s priorities for 2022. The top priority is to work with the other federal banking agencies, the Federal Reserve and the Comptroller of the Currency, to revise and strengthen the CRA. Another priority is to address the financial risks that climate change poses to banking organizations.</p> <p>On March 30th, the FDIC released a request for comment on draft principles that would provide a high-level framework for the safe and sound management of exposures to climate-related financial risks. The principles target entities with over \$100bn in assets.</p>
Americas	USA	The Environmental Protection Agency (EPA) releases new state-level data on greenhouse gas (GHG) emissions, and it updates the state GHG inventory and projection tool. The new data provides states with additional information on how to catalog and reduce GHG emissions.
Asia	China, Hong Kong	The Financial Reporting Council (FRC) announced the establishment of the Sustainability and Climate Action Task Force . This task force will provide recommendations to the FRC board on strategic actions that should be considered in relation to the global developments in financial and sustainability reporting.
Asia	India	The Securities and Exchange Board of India released a consultation paper seeking public comments on a proposed framework to regulate ESG rating providers.
Asia	Japan	The Government of Japan announced that by the summer of 2022, it will publish due diligence guidelines for preventing human rights abuses in corporate supply chains. A panel will be set up this month to draft the guidelines. It is also announced that Japan will consider further measures, including passing its own law, to tackle human rights issues in supply chains.
Asia	Japan	The Japanese Financial Services Agency (JFSA) formed a subcommittee that will develop principles for ESG ratings and data providers, drawing on last year’s recommendations from IOSCO. The principles are intended to ensure transparency of data methodologies and reduce conflicts of interest.
Asia	Singapore	The Institute of Banking and Finance Singapore (IBF) and the Monetary Authority of Singapore (MAS) published a list of 12 technical skills and competencies needed by individuals working in sustainable finance. The list identifies knowledge on climate change policy developments, natural capital, green taxonomies, carbon markets, and decarbonization strategies as desirable. It also suggests it is beneficial to know how sustainability is applied across major functions in the financial sector.

Europe	EU	The EU Commission adopted the Complementary Delegated Act of the EU Taxonomy “in principle.” The act adds natural gas and nuclear energy activities to the EU Sustainability Taxonomy, which allows these activities to qualify for taxonomy-aligned investment if certain criteria are met. For instance, facilities must fully substitute their natural gas activities with activities that use renewable or low-carbon gases by 2035.
Europe	EU	ESMA published its sustainable finance roadmap for 2022–2024 . The document describes activities to converge ESMA’s supervision with that of national competent authorities (NCAs), such as training, data mapping, and issuing guidance. Regarding the UCITS Directive, ESMA plans several activities. For example, enhancing UCITS-related legislation’s consideration of sustainability impacts in investment decisions and assessing the need to amend, clarify, or interpret the UCITS Directive.
Europe	EU	The EBA updated methodology for assessing third-country exposures. Under the CRR, certain exposures to entities located in non-EU countries can be treated, in terms of risk-weights, as exposures within the EU. The methodology includes two questionnaires. The first includes general questions on relevant requirements and principles. The second contains more detailed questions, such as on the disclosure of ESG risks. Question 27 asks if the third-country national laws – like article 449a of the CRR – require ESG risks to be disclosed, and it asks what specific information is to be disclosed.
Europe	EU	The EU Commission published its proposed Directive on Corporate Sustainability Due Diligence (CSDD Directive). If adopted, this directive would require companies to conduct environmental and human rights due diligence on their activities and business relationships.
Europe	EU	The EU Council issued its position on the CSRD . It proposes several amendments to the proposed directive, including changing the scope, and altering the deadlines. The Council’s position gives its presidency a mandate to pursue during discussions with the EU Parliament, which are expected to start in the spring of 2022.
Europe	EU	The Platform on Sustainable Finance published its final report on the EU social taxonomy. The EU Commission will now analyze the report and propose amendments to the Taxonomy Regulation.
Europe	France	Banque de France published an article about French insurers’ investments. The bank reveals that green, socially responsible, and solidarity-labelled instruments continued to be a trend in 2021 and amounted to almost 5 percent of the French insurance industry’s investments. In addition, ACPR released a report on the evolution of insurance industry practices regarding climate-related risk since 2019.
Europe	Germany	BaFin published the responses to its consultation paper on machine learning in risk models. Together with the BDAI Principles the authority previously published, the paper also explores the development and ap-

		plication of machine learning risk models in the context of existing oversight provisions under the Basel framework. The consultation feedback will serve as the foundation for dialogue with enterprises.
Europe	Italy	Banca d'Italia released a working paper , "Toward a green economy: the role of central bank's asset purchases," which studies the effects of a central bank's purchases of green bonds. The authors find that a permanent green bond purchasing program helps reduce carbon emissions but has a minimal impact on carbon amounts. The largest effects were found when central banks undertake these purchases in the early stages of a company's green transition.
Europe	Norway	Finanstilsynet released a report called " Climate risks in Norwegian banks " in which it analyzed two possible pathways for the Norwegian economy based on scenarios from the NGFS – an orderly transition and a disorderly transition. In a disorderly scenario, the report show that Norwegian banks will face significant but manageable corporate loan losses.
Europe	Portugal	Banco de Portugal released a report entitled " Acting for sustainability: The Banco de Portugal's approach to ESG sustainability 2022-25 " in which it lays out its ESG plans for the next few years. Priorities include financial system robustness, protection of the banking market, recovery and resilience of the economy, confidence and influence on society, and governance and internal management.
Europe	UK	The Department for Business, Energy and Industrial Strategy (BEIS) issued non-binding guidance to help companies understand how to meet the new climate-related financial disclosure requirements under the CFD Regulations.
International	BIS	The Bank for International Settlements (BIS) launched an Asian Green Bond Fund which will help channel central bank reserves towards green projects on the continent. Along with BIS's two existing green bond funds, this addition will bring the total amount of green bonds managed by BIS to \$3.5 billion. Central banks will have the ability to invest in high-quality bonds that align with international sustainability standards – issued by corporates, sovereigns, and international financial institutions.
International	NGFS	The Network for Greening the Financial System (NGFS) released a statement in which it acknowledged the potentially significant macroeconomic implications of nature-related risks and biodiversity loss. Ignoring these risks could threaten financial stability. The statement accompanies a report by an NGFS study group on 'Biodiversity and Financial Stability' (see section 2.3).
International	FSB	The Financial Sustainability Board (FSB) published an open letter to the G20 finance ministers and central governors outlining its work priorities for 2022, which follow the FSB's roadmap for addressing climate risks. The letter highlights that the FSB's work in 2022 will contribute to all four pillars of the FSB roadmap: disclosures, data, vulnerabilities analysis, and regulatory and supervisory approaches. This includes supporting the development and widespread adoption of the IFRS Foundation's new International Sustainability Standards Board (ISSB).

2.2 Open Consultations

Region	Jurisdiction	Entity / Consultation	Deadline
Americas	USA	The Department of Labor (DOL) seek public comment on what actions, if any, the department should take under federal law to protect retirement savings and pensions from risks associated with climate change.	May 16, 2022
Americas	USA	The Securities and Exchange Commission released a proposed rule for consultation which lays out a climate-related reporting framework.	May 20, 2022
Americas	USA	FDIC Request for Comment on Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions	June 3, 2022
Europe	EU	ESMA has called for evidence on the methodology it will use to assess the climate risks of central counterparties (CCPs) during its scheduled climate stress tests. This call falls under the Strategy's aim to "improve the financial sector's resilience and contribution to sustainability."	April 21, 2022
Europe	Switzerland	The Federal Council opened a consultation on a proposed ordinance on climate reporting by large companies. The ordinance would make the recommendations of the TCFD mandatory.	July 7, 2022
International	ISSB	The International Sustainability Standards Board released two exposure drafts for comment, a draft on general sustainability disclosure requirements (IFRS S1) and a draft on climate-related disclosure (IFRS S2).	July 29, 2022

2.3 Initiatives, Frameworks, and Tools

[TNFD releases Beta Framework](#)

On March 15th, the Taskforce on Nature-related Financial Disclosures (TNFD) released a beta version of its nature disclosure framework. The framework is divided into three core pillars: Fundamentals for understanding nature for market participants, the TNFD draft disclosure recommendations, and the LEAP Process for Nature-related Risk and Opportunity Assessment. The framework is accessible online through the interactive [TNFD framework platform](#). The TNFD has emphasized a consistency of approach and language with the Taskforce on Climate-related Financial Disclosures (TCFD) and other climate/nature-relevant disclosure frameworks. The ultimate aim of the TNFD as a risk management and disclosure framework is to shift global financial flows from nature-negative outcomes

[NGFS-INSPIRE Occasional paper: Central banking and supervision in the biosphere](#)

The NGFS-INSPIRE joint Study Group on Biodiversity and Financial Stability has released its final report, which concludes that biodiversity loss is a ‘potentially significant’ threat to financial stability. Stemming from the reliance of the economy (and financial assets) upon ecosystem services, and the potential transition of the economy towards a ‘nature-positive’ model, biodiversity risks can affect financial institutions through a range of risk transmissions channels across the economy, and to sovereigns. Considering that biodiversity-related financial risks may translate into financial risk stripes, the report argues that such risks should be considered as within the mandates of central banks and financial supervisors. Drawing on examples from the practices of NGFS member supervisors in areas such as policy research, engagement, and initial exposure assessments, the report sets out a toolbox of actions in seven areas for consideration.

[World Bank framework for Sovereign Climate and Nature Reporting](#)

A new World Bank report sets out proposals for framework for sovereign entities to report on climate and nature-related risks and opportunities. Considering the increasing significance of climate and nature-related risks for sovereign debt, where the crystallization of risks could potentially lead to impairments in credit quality, exacerbation of existing default risks, and increases in cost of capital, greater clarity and consistency of disclosure of such risks is necessary to enable creditors to engage effectively with sovereigns, and to identify where new financial instruments could be developed to support investments in nature conservation.

[OECD sets out agenda for Financing a Water Secure Future](#)

This document describes the key challenges and opportunities related to the financing of water security activities, as well as to the impacts that water issues may cause in financial transactions generally. It discusses, for instance, water and sanitation services, water resources management, agricultural water, and managing water-related risks. Moreover, the report includes measures to foster the financing of water-related investments.

2.4 Research and Insights

[IEA: Global CO2 emissions reach highest level in history](#)

The International Energy Agency (IEA) released the “Global Energy Review: CO2 Emissions in 2021,” in which it found historically high CO2 emissions last year. 2021 emissions were 6% higher than in 2020, reaching 36.3 gigatonnes (Gt). Despite temporary CO2 emission reductions due to COVID-19, the rapid economic recovery has increased carbon emissions, more than reversing the pandemic-caused reduction of 1.9Gt.

[Governments reach agreement to end plastic pollution](#)

The United Nations Environment Program (UNEP) announced that 175 countries agreed to a resolution to “End Plastic Pollution” and create a binding international treaty to that effect by 2024. The agreement covers the production, design, and disposal of plastic.

[Columbia University: Mapping of GHG emissions from State-owned Enterprises](#)

Researchers at Columbia University released a paper entitled, “Greenhouse Gas Emissions from State-Owned Enterprises: A Preliminary Inventory,” including a direct accounting of state-owned enterprises’ (SOEs) direct emissions. The report finds that SOEs are responsible for 7.49 gigatons of CO2 equivalents

annually in Scope 1 emissions. 69% of these emissions come from companies owned by the Chinese governments, with smaller shares from Russia, India, Indonesia, South Africa, South Korea, Saudi Arabia, and Mexico. The power sectors across these countries are the main source of emissions.

Nature: methane emissions rising faster than expected

An article published in *Nature* warned that methane emissions are rising dangerously fast. Atmospheric methane concentrations rose higher than 1,900 parts per billion in 2021 – triple pre-industrial levels. This rise underscores the importance of the Global Methane pledge signed by more than 100 countries at COP26. Signatories agreed to cut methane emissions by 30% between 2020 and 2030.

Deforestation emissions higher than previously thought

A study published in *Nature Sustainability* finds an acceleration in forest carbon loss in the 21st century, concluding that current efforts to reduce forest loss are not successful; monitoring deforestation is more important than ever. Global gross tropical forest carbon loss has doubled from 2001-2005 to 2015-2019, contradicting other models which have shown no significant change.

Amazon Rainforest has significantly lost resilience, and may reach tipping point

Research published in *Nature Climate Change* shows a significant loss in the resilience of the Amazon rainforest since the early 2000s – more than 75% of the forest has lost resilience over the past two decades. The forest is crucial to sustaining biodiversity, climate, and the global carbon cycle, but climate change and deforestation have pushed the Amazon close to a tipping point and increased the threat of rainforest dieback.

Imminent Tipping Point in Permafrost Stability

Carbon-rich permafrost peatlands are coming under significant threat from climate change, research shows, threatening their viability over the coming decades. About 75% of this peatland across northern Europe and western Siberia could be unable to maintain permafrost by the 2060s – and this is only under a moderate warming scenario. Permafrost peatlands contain about 40bn tons of carbon, which if released would drastically accelerate global warming.

3. MARKET SNAPSHOT⁵

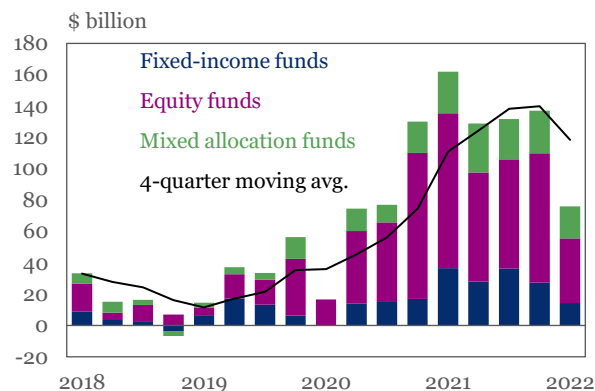
Short term volatility: The sharp reversal in [global risk appetite](#) amid heightened geopolitical tensions, rising inflationary fears and higher borrowing costs prompted a marked fall in ESG-labelled investment flows in the first quarter of 2022. At \$75 billion in Q1, ESG fund flows were at their lowest ebb in seven quarters (Chart 1).

The retrenchment in flows was mainly in equity funds as increased volatility in tech shares reduced investor appetite for ESG funds that are heavily invested in tech (Chart 2). Higher oil prices were also a factor as investors channeled funds into (non-ESG) energy stocks. Overall, ESG-labelled equity funds attracted some \$41 billion of net cash flows in Q1, with monthly flows in March 2022 dropping to their lowest level since March 2020, when the COVID-19 shock triggered large outflows from ESG funds.

Flows to ESG fixed-income funds were down sharply—to \$14 billion in Q1, down from \$27 billion in Q4 2021. While rising interest rates hit investor demand for bonds of all stripes in Q1, investment grade ESG bonds outperformed their conventional peers in Q1. However, high-yield ESG bonds underperformed their conventional counterparts—which were buoyed by energy sector bonds, particularly in the first two months of the year (Chart 3).

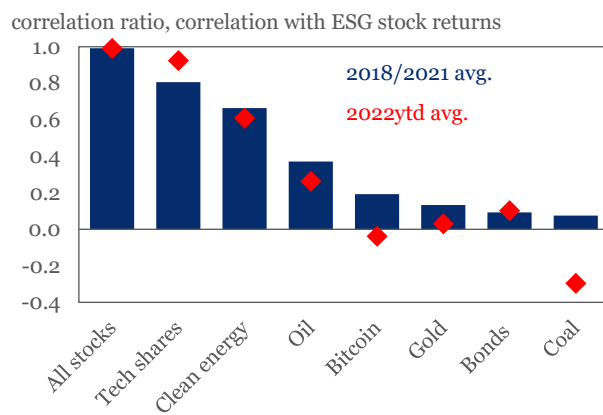
Mixed allocation funds saw inflows of over \$20 billion in Q1 2022—the slowest pace of inflows since Q4 2020.

Chart 1: ESG funds saw inflows halve in Q1 2022



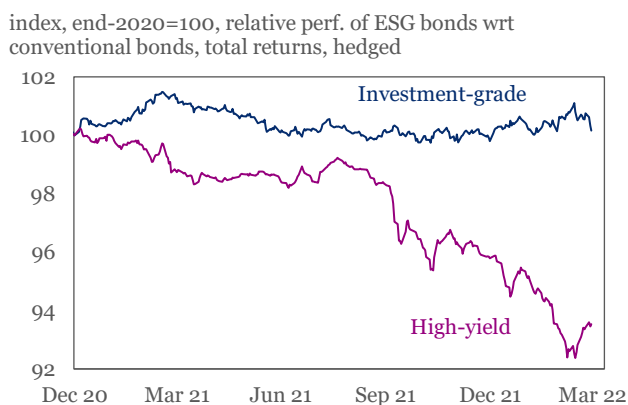
Source: Morningstar, IIF

Chart 2: ESG stocks remain highly correlated with tech shares



Source: IIF, Bloomberg

Chart 3: Investment-grade ESG bonds outperformed their conventional peers in Q1



Source: Bloomberg, IIF

⁵ Authors: Emre Tiftik, Director of Sustainability Research; Paul Della Guardia, Financial Economist; Raymond Aycock, Research Analyst

4. UPDATE ON IIF SUSTAINABLE FINANCE ACTIVITIES

SFWG Outputs and Sustainable Finance Research

- [Green Weekly Insight: Tough Q1 for ESG markets, better times ahead \(4/7/2022\)](#)
- [Voluntary Carbon Markets Update – Q1 2022 \(4/7/2022\)](#)
- [Green Weekly Insight: Shift from Russian energy to speed up the EU’s climate transition \(3/31/2022\)](#)
- [Green Weekly Insight: Blended finance for climate—the time is now \(3/24/2022\)](#)
- [Green Weekly Insight: ESG-linked sukuk market—promising but still niche \(3/17/2022\)](#)
- [IIF Responds to ESMA Call for Evidence on Market Characteristics for ESG Ratings Providers in the EU \(3/15/2022\)](#)
- [IIF Briefing Note on IPCC A6 WGII Report \(3/3/2022\)](#)
- [Integrity Through Alignment: A 2022 Roadmap for Global Standards and Market-led Approaches in Sustainable Finance \(2/17/2022\)](#)
- [IIF Sustainable Finance Monitor – January 2022](#)
- [Sustainable Debt Monitor: Boom time! \(1/27/2022\)](#)

Upcoming Events and Webinars

- [April 21 - 2022 IIF Sustainable Finance Roundtable: Alignment, Integrity and Transition Finance](#)

Forthcoming IIF Sustainable Finance Meetings

- April 28 – Joint meeting of the Sustainable Finance Policy Expert Group (SF-PEG) and Sustainable Finance Data, Disclosure and Classification (SF-DDC) Expert Group
- May 19 – Joint meeting of the Sustainable Finance Policy Expert Group and Risk and Alignment Methodologies Expert Group

The IIF sustainable finance team sends regular updates on the schedule of activities for 2022. Please send any questions or requests to Ellen Ehrnrooth (eehrnrooth@iif.com).