LACADI
INICIATIVA DE DIVULGACIÓN DE ACTIVOS CLIMÁTICOS DE AMÉRICA LATINA

ArticuLAC
Comunidad de Práctica sobre articulación público-privada para la acción climática en Latinoamérica

POLICY BRIEF

Opportunities to align institutional investments with climate goals in Latin America and the Caribbean

This document has been prepared for the purpose of disseminating the learnings of the **Latin American Climate Asset Disclosure Initiative (LACADI) and the Community of Practice on public-private articulation for climate action in Latin America (ArticuLAC).**

LACADI is a joint effort coordinated by Transforma in Colombia and implemented by the Mexican Climate Initiative (ICM) in Mexico and Libélula in Peru. This project is part of The International Climate Initiative (IKI). The German Federal Ministry of Economic Affairs and Climate Action (BMWK) implements this initiative on the basis of a decision adopted by the National Parliament of the Federal Republic of Germany.

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Author: Lorena Téllez Farfán, LACADI/Transforma

Content contribution and editorial revision: Ana María Majano, LEDS LAC and CLADCS/INCAE; Doris Arévalo, sustainable finance advisor, Colombia; Nathaly Uribe and Claudelle Brito, Banco Popular, Dominican Republic; Severin Carminati, Fundación Popular, Dominican Republic.

Supervision: Pablo Rojas, GIZ/Euroclima, Ronald Arce, CLACDS/INCAE, Margarita Gutiérrez, LACADI/Transforma.

Style revision: Martha Josefina Espejo Barrios

Layout: Leidy Sánchez Jiménez

Additional information about ArticuLAC and LACADI at:
https://www.ledslac.org/comunidades-de-practica/sector- privado/ y https://lacadi.transforma.global/

Contact information: cdpsectorprivado@euroclimaplus.org; lacadi@transforma.global

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The increasingly evident effects of climate change and the global efforts to move towards low-emission resilient development pose risks and opportunities for every kind of company. For financial entities and investors, these risks and opportunities are directly related to the activities to which their resources are allocated.

Reaching net-zero emissions by mid-century is a must to prevent the global temperature rise from exceeding 1.5°C (IDB and Deep Decarbonization Pathways for Latin America and the Caribbean, 2019). In Latin America and the Caribbean (LAC), achieving this goal could cost between 3.7% and 4.9% of the regional GDP (ECLAC, 2023a), representing great financing needs, but also many opportunities for investment and development.

Institutional investors, such as pension fund administrators (AFP), insurers and other fund administrators, are in the position to significantly contribute, to the achievement of these investment levels. However, allocation of institutional investor funds towards deliberate financing of sustainable development and climate action is still low in LAC. On the other hand, the performance of their portfolios could ultimately be threatened depending on how resilient their investments are and how much they leverage opportunities derived from climate transition.

The Latin American Climate Asset Disclosure Initiative (LACADI) has been working, since 2022, with institutional investors from Colombia, Mexico and Peru, with a focus on insurers and AFPs incorporate climate change risk and opportunities into their investment decisions. In October 2023, LACADI started collaborating with the Community of Practice (CoP) on Public-Private Articulation for Climate Action in Latin America (ArticuLAC) to promote a dialogue among the members of the CoP and other actors that would help identify action lines, both for investors and for the public sector, so that the region can leverage the potential of institutional investors to contribute to the fulfillment of their climate and sustainable development goals. This document is based on the results of that work.

LACADI IS AN INITIATIVE:

COORDINADA POR TRANSFORMA

IMPLEMENTADA POR icm INICIATIVA CLIMÁTICA DE MÉXICO libélula

FINANCIADA POR Ministerio Federal de Economía y Protección del Clima IKI INTERNATIONAL CLIMATE INITIATIVE en virtud de una decisión del Bundestag alemán

ARTICULAC IS A JOINT INITIATIVE OF:

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Private investment needs and opportunities to fulfill climate goals in Latin America and the Caribbean

The Nationally Determined Contributions (NDC) express the commitments, in terms of mitigation and adaptation, proposed by the countries signatory countries of the Paris Agreement. The NDCs, along with the National Climate Change Adaptation Plans (NAP) and the Long-term strategies (LTS) outline each country's individual mid- and long-term climate roadmap. However, complying with such roadmaps requires to take them into account during the strategic and financial planning, as well as in the expansion and updating of each country's regulatory frameworks.

It is estimated that a transition towards a global carbon-neutral economy by 2050 could cost around USD 275 trillion in

total, involving an increase of 60% of current global spending on low-carbon assets (McKinsey, 2022). In LAC, the transition would cost approximately USD $2.1 trillion to USD 2.8 trillion between 2023 and 2030, which requires an annual investment of USD $215 billion to USD $284 billion (3.7% - 4.9% of the regional GDP) (ECLAC, 2023a). On the other hand, the cost of inaction on climate change could be a decrease in the regional GDP of up to 23% in 2050 and 74% in 2100 (ECLAC, 2023a).

In Latin America, the opportunities to move towards a carbon-neutral economy are found mainly in the energy and transportation industries, through the electrification of the industries, transportation and construction, leveraging the region's high potential for renewable energies (IEA, 2023; Santikarn et al., 2020; BID 2020; IDB and Deep Decarbonization Pathways for Latin America and the Caribbean, 2019). On the other hand, the impact of deforestation and agricultural activities on greenhouse gas (GHG) emissions and the urgency to adapt to climate change require giving more importance to the sustainable use of nature within climate action. Opportunities arise within these fields to generate profitable mechanisms from nature-based solutions, comprehensive management of water resources, circular economy and bioeconomy, which could leverage the use of agroforestry and silvopastoral systems, sustainable nature-based tourism and mixed production models, as well as the conservation of natural ecosystems, which also work as carbon sinks (OIT, 2022; ECLAC, 2023a).

Public policy is crucial for the private sector to leverage these opportunities and contribute to the fulfillment of the national goals. According to discussions held within the context of the work with ArticuLAC and studies on the matter, private investment alignment with the Paris Agreement objectives requires the following from the government, among others:

- Coherent policy frameworks, with clear mid- and long-term priorities aligned with the instruments that make up the national climate strategies, providing legal and fiscal certainty.
- Spaces for the engagement of the private sector and civil society in investment planning processes.
- Adequate information to enable decision making, including climate scenarios, funding needs and investment costs.
- Capacity building for both public institutions and private sector personnel.
- Facilitating reporting of climate change risk and opportunities, as well as financial flows related to climate action, environmental management and social responsibility (University of Cambridge, s.f.; ECLAC, 2023b).

Opportunities and challenges for institutional investments

Institutional investors play a crucial role in long-term financing for the economic growth and development of nations. According to the OECD (2021), capital in this sector within its member countries reached USD $1 trillion in sustainable assets by 2019, of which 3.7% was required to close the funding gap for activities related to fulfilling the Sustainable Development Goals in 2020.

Identifying the sectors prioritized by the NDCs and the more urgent needs in each country, together with the convergence of financing efforts through blended finance, open great opportunities for institutional investors to contribute to sustainable development and climate action in LAC (OECD, 2021). However, the allocation of pension, insurers and other institutional investors funds to climate and sustainable development goals is still low in the region, mainly being directed towards stocks and bonds.

1 The translation of billions from English to Spanish means one billion dollars, just as an English trillion translates as one billion dollars (Orgaz, 2021).

AFPs may play a relevant role in financing adaptation and mitigation and will benefit from the fair transition that seeks to implement decent employment and increase the number of green jobs in the region, which in turn would increase the contribution base (IDB & ILO, 2020). By the end of 2022, the pension fund investment portfolios in 8 Latin American countries reached an amount close to USD $607 billion and an average of USD $76.000 per country. These amounts were mainly allocated to state instruments (39,52%), followed by foreign investments (27,54%) and corporate instruments (16,19%) — predominantly fixed income instruments (FIAP, 2023).

Insurers play an important role in building resilience and reducing risks through adaptation (Ivanova et al., 2021)[2], but they may also contribute to climate action as investors. Insurer investments in 18 Latin American countries between 2021 and 2022 exceeded USD $497 billion, of which over 50% were fixed income investments, followed by variable income instruments and debt financing (MAPFRE Economics, 2023). However, these resources are not yet being used to their full potential to finance the investments needed to meet climate targets.

The low participation of institutional investors in climate action financing is partially due to regulations that limit amounts and destinations, the high risk without mitigation mechanisms, and a weak transparency that affects reliance in investments (OECD, 2021). Nevertheless, countries such as Mexico, Costa Rica, Colombia, Peru, Brazil and Chile have been including requirements in their regulations so that institutional investors adopt environmental, social and corporate governance (ESG) criteria in their investments (Atehortúa, 2021; ANAFAP, 2023), which could generate a greater appetite for sustainable investments.

Sustainable funds and thematic bonds are instruments that may be used to direct institutional investors resources to the financing of actions defined in the NDCs. However, it hasn't been easy for sustainable funds to establish themselves in LAC due to being perceived as high risk, having limited financial markets, it doesn't exist proper regulatory frameworks and ESG reporting by companies is scarce (ECLACl, 2023b).

Meanwhile, thematic bonds have been more popular, particularly the green, social, sustainable and sustainability-related ones (OECD, 2022). Due to the regulatory and current market conditions, thematic bonds are one of the most viable instruments to align the institutional investor financial flows with the NDCs. Between 2021 and 2022, sustainable bonds represented 51% of LAC's debt, with an average year-on-year increase of 238% since 2019, being Brazil and Chile the largest emitters with UDS $11.9 billion and USD $2 billion, respectively (Climate Bonds Initiative, 2023).

The challenge for the region is to strengthen their conditions so that pension funds, insurers and other institutional investors can identify opportunities deriving from the fulfillment of the NDCs that respond to their regulatory frameworks and their trust and performance requirements. These requires concrete actions by NDC financing planners, financial sector regulators and supervisors, financial institutions themselves, international cooperation and other relevant actors.

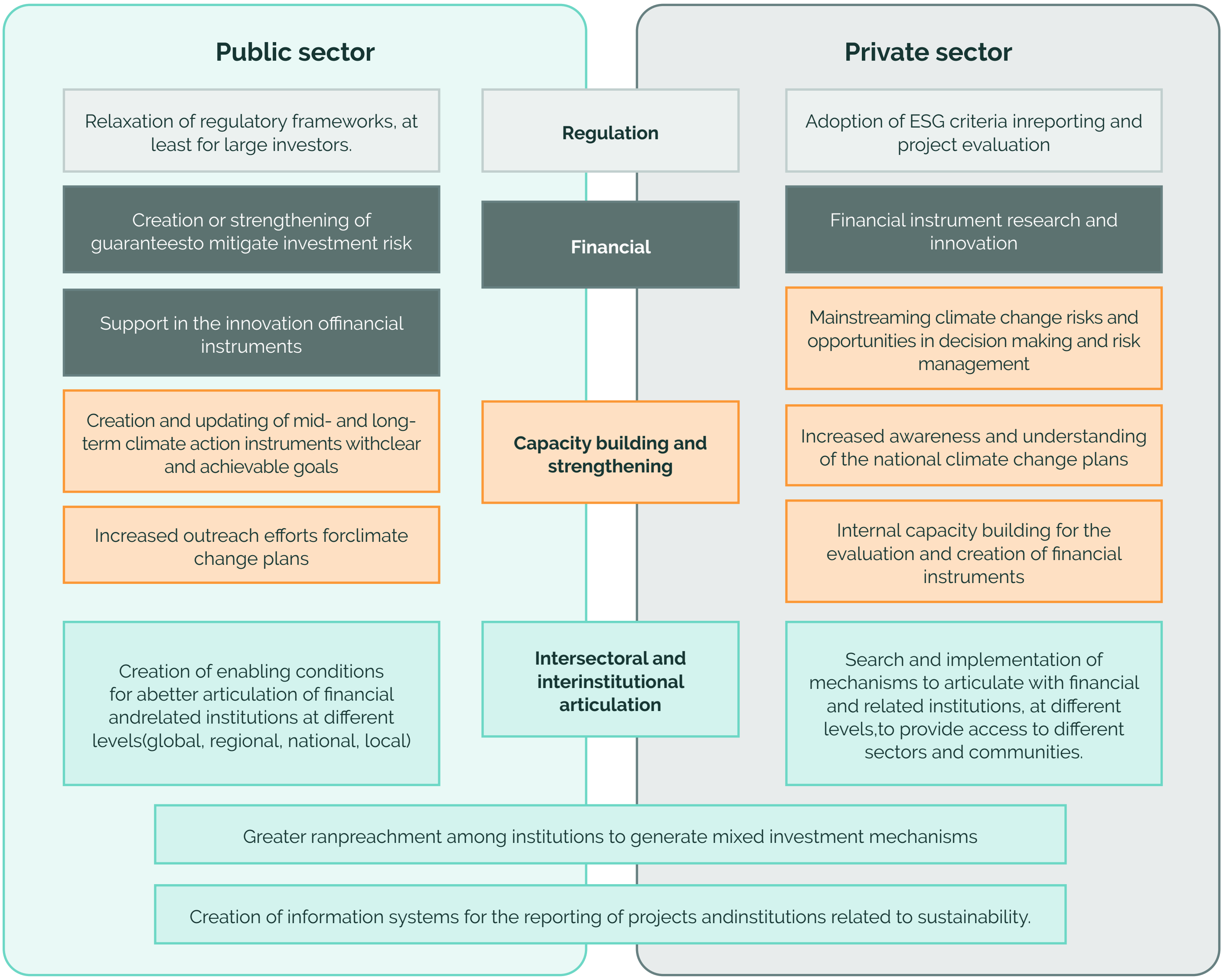
Action lines to align institutional investments with national climate goals

There is a need for greater dialogue and articulated work between the public and private sector to continue leveraging the opportunities to issue sustainable bonds to institutional investors and promote their participation in other financial mechanisms, such as sustainable funds and public-private alliances.

Figure 1 shows the actions identified by ArticuLAC members and other actors that partook in the work sessions organized to discuss the opportunities and challenges for the alignment of institutional investments with climate goals.

2 The International Monetary fund estimates that a coverage of between 15% and 30% of the GDP of the Caribbean countries, and of 10% to 20% of the GDP of Central America, Panama and the Dominican Republic could cover 99% of the climate change-related fiscal costs (Ivanova et al., 2021; IMF, 2021).

Figure 1. Actions identified to align private sector investment with national mitigation and adaptationgoals



Source: own elaboration.

The content in Figure 1 involves 4 major action lines:

1. In the **regulatory** field, there is a need for the public sector to relax frameworks for investors, so that they can access more market options. On the other hand, the private sector needs to strengthen ESG adoption criteria, both in terms of reporting and project evaluation.

2. At a **financial** level, the public sector should strengthen or create different guarantee mechanisms, both for credit and performance, so that private actors can access investments and projects for which there is a greater perception of risk. This can be attained through enabling mechanisms that allow for greater participation of development banks that work as a risk buffer. Likewise, there needs to be a greater articulation between the public and private sectors to find investment opportunities through instrument innovation, which can be proposed by the private sector.

3. In terms of **capacity building**, the public sector should enable the private sector access to information on national climate plans and goals; on the other hand, the latter should increase its awareness regarding the information generated by the government about climate and, particularly, incorporate risk and opportunity analysis and management to their planning and project evaluation. Financial institutions should integrate and mainstream climate change risks and opportunities (mitigation and adaptation) in the creation of products, identification of investment objectives and in the areas of sales and services (CCADI, 2023).

4. Lastly, improving intersectoral and interinstitutional articulation between both sectors to facilitate the financial flow between institutions at different levels and management of climate change related risks is key. This can be made feasible by strengthening mixed financing, which can attract big international thematic funds, such as those being created and monetized as a result of the United Nations Framework Convention on Climate Change (UNFCCC). Likewise, the creation of systems that facilitate the consultation and dissemination of information is a strategy with great potential to improve transparency and trust between institutions and catalyze sustainable investments in the region.

Moving forward along these lines requires actions from both the public sector and the private investors, in collaboration with other actors, such as academia, civil society and international cooperation agencies that work towards directing financial flows needed to attain climate goals and promote low-emission resilient development in the region. LACADI and ArticuLAC seek to continue to collaborate with this process.

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