

## Chapter 3. Acting on Climate Risks and Climate Finance through the Banking Sector

**Climate-related risks in the financial sector and large climate financing gaps pose a dual challenge for banking authorities in EMDEs.** Climate risks, if not addressed, could significantly reduce output in EMDEs; they also present risks to financial stability and may adversely interact with other financial sector challenges such as those discussed in previous chapters. EMDEs also face a significant gap in climate financing: excluding China, they represent about 25 percent of global output but account for just 14 percent of global climate finance flows, with more than 50 percent stemming from public sources. Only 16 percent of climate financing in EMDEs (ex China) goes to adaptation, nearly all of it stemming from public sources (98 percent). Moreover, while advanced economies and China can rely on domestic sources for over 90 percent of their climate finance, in EMDEs (ex China) less than half of climate finance is domestic in origin. Moreover, 28 percent of EMDE banks provide no climate financing at all, and for 60 percent of EMDE banks climate finance accounts for 5 percent or less of their lending portfolios.

**EMDE banking authorities are addressing the climate risks specific to their financial sectors in innovative ways.** EMDE banking authorities are adopting climate risk management tools and developing supervisory approaches. In doing so, they should mitigate any unintended consequences for financial inclusion. Most progress to date has been in middle-income EMDEs, where banking authorities are proactively strengthening their approaches to climate risk by deploying these regulatory tools in a sequenced, proportional, and innovative manner. Risks to nature are also starting to be assessed, which is important for EMDEs given their extensive adaptation needs.

**EMDE banking authorities are also enabling climate finance and need guidance on how to do so without compromising their primary financial stability objective.** Banking authorities globally are testing new approaches to promoting climate finance. These approaches range from adjusting interest rates on lending facilities to requiring banks to direct lending to green activities. Most of these are relatively new and empirical evidence about their suitability and effectiveness, as well as their potential to interfere with primary financial stability mandates, is still emerging. Some efforts, such as a well-designed post-disaster regulatory response, can encourage lending and enhance climate resilience. For other approaches, such as providing preferential interest rates to commercial banks for on-lending to designated green sectors, the “jury is still out.” Other tools such as directed

*lending have been deployed for different purposes in the past with limited success and are currently not recommended for mobilizing climate finance.*

***To meet the dual challenges of climate risk management and climate finance mobilization, banking authorities need to continue addressing gaps and strengthening coordination regarding data, modeling methodologies, taxonomies, and disclosure standards.*** Such interventions are fundamental to improving climate risk management and raising investment levels. Adoption of green and sustainable taxonomies, which define and classify investments and activities that support climate targets, will be essential, yet today they cover only 10 percent of EMDEs compared with 76 percent of advanced economies.

***Though banking authorities have an important role to play given the dominance of the banking sector in EMDEs, closing the climate financing gap requires broader policy support and financing from beyond the banking sector.*** Some governments look to central banks and banking authorities for support, but they should not infringe on these institutions' operational independence. Moreover, prudential or central bank measures should not interfere with institutional core mandates and cannot substitute for necessary broader government interventions when tackling climate change, including carbon pricing, fiscal policies, and sectoral regulations. Challenges related to climate finance are often symptomatic of broader issues with mobilizing development finance in EMDEs. This is partly due to the absence of well-functioning capital and insurance markets in many EMDEs; such markets need to be developed to provide access to long-term funding for new green technologies as well as critical climate infrastructure and climate risk resilience instruments. Institutions such as national development banks – which have \$19 trillion in assets – and credit guarantee institutions can play a major part in raising more climate finance if deployed judiciously and in a targeted fashion.