THE IMPORTANT ROLE OF GREEN FINANCE IN THE TRANSITION

DOI: 10.58867/DQGL9965

Transitioning to a low carbon and resilient economy involves large investments across sectors sustained over decades. Access to finance will be a crucial component to facilitate these investments. This article investigates what reforms are needed in Türkiye's financial sector to advance financing of climate-related investments while improving management of climate-risks in finance sector portfolios.

Etkin Ozen* & Daniel Besley**

Keywords: Climate Change, Financial Stability, Green Finance, Investments, Türkiye.

TPQ
Fall 2023

* Etkin Ozen is a Senior Financial Sector Specialist at the World Bank Türkiye.
** Daniel Besley is a Senior Climate Change Specialist at the World Bank.

Türkiye's financial sector plays a crucial role in delivering on the green agenda and mobilizing capital for climate action, and yet climate change poses risks to financial stability and the soundness of institutions. As the COVID-19 crisis has shown, major disaster events have direct impacts on the financial sector. They heighten levels of uncertainty regarding the medium- to long-term macro-economic outlook and growth, increase public and private sector financing needs, cause structural changes to the economy, and influence the distribution of wealth and income. Climate and environmental crises[1] can have a similar impact and threaten the stability of financial institutions and systems. Due to its specific geopolitical position. Türkiye is also exposed to climate and environment migration more than other countries. With increasing knowledge and awareness of these risks, more frequent occurrence of extreme weather events and awareness of transition-related risks, Türkiye's financial sector must be able and ready to respond to a climatic crisis.

Large investments are needed to address climate change. Based on the World Bank's Country Climate and Development Report (CCDR), Türkiye needs to prioritize climate mitigation, adaptation, and resilience to ensure sustainable growth and needs to invest $165 bn over 2022–40 in addition to the $482 bn baseline in the power, residential, and transport sectors.[2] Half of these investments are expected to come from the private sector. Increasing appetite by international investors for green investments[3] are an opportunity for Türkiye to crowd in private capital for achieving climate targets.

While public spending is expected to play a key role in the transition, meeting the investment needs required for resilience and reaching net zero requires more private investments toward resilient and zero-carbon options. The financial sector needs to mobilize capital for the green transition; yet green finance[4] in Türkiye comprises mostly short-dated bank lending for renewable energy while long-term finance is needed to address investment needs. Banks have been the main issuers of green Eurobonds,[5] but Türkiye overall is lagging behind

1) Both physical (sudden, like a cyclone, and slow-onset, like changing weather patterns), and transitional (related to the global transition to low-carbon and sustainable economies that triggers changes in regulations and investor and consumer behavior).

2) Türkiye Country Climate and Development Report (CCDR), 2022, World Bank.

3) In 2020, investors demanding green and sustainable investments represented over a third — more than USD 35 trillion — of total assets under professional management (Global Sustainable Investment Alliance, 2021).

4) Green finance includes all lending and investment contributing to climate mitigation, climate adaptation, resilience, and other environmental objectives. Climate finance refers to local, national, or international financing that is drawn from public, private, and alternative sources to support mitigation and adaptation actions that will address climate change.

5) Green bonds are bond instruments where the proceeds, or an equivalent amount, will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible green projects. In Türkiye, the criteria stipulated in

peer emerging markets in terms of green issuance.[6] Barriers to the growth of green capital market instruments are primarily macro-financial, however challenges also remain regarding knowledge and institutional capability, limited demand for green instruments by domestic institutional investors, and the need to accelerate efforts towards a holistic regulatory and policy framework. Neither the public sector nor banks will be able to meet the investment needs for the green transition alone and private capital will need to be mobilized through a range of instruments.

At the same time, climate change poses risks to financial stability and institutions. Physical and transition risks can affect credit, market, underwriting, operational, and liquidity risks, posing risks to the profitability and solvency of financial institutions. Banks, which hold more than 90 percent of total financial system assets, are exposed to both physical and transition risks. Physical risks—including droughts, forest fires, floods, and landslides—affect economic performance and the value of assets, potentially leading to a rise in nonperforming loans (NPLs). Transition risks need to be monitored, especially if the transition to a low-carbon economy is rapid and banks have large exposure to carbon-intensive and transition-sensitive sectors, potentially leading to NPLs in these sectoral portfolios. Risks can differ significantly across banks, depending on their respective exposures.

A holistic approach is needed for greening Türkiye's financial sector. Considering the nature of investments needs, a range of financing options need to be available, including green loans (especially long-term) and green capital market instruments. Capital market instruments include both equity and debt instruments. While diverse financing instruments are needed, they need to go hand-in-hand with creating an enabling environment for green finance to flourish in Türkiye while preparing for increasing financing needs as the frequency and severity of natural disasters increases. This proposal aims to take a holistic view towards these interrelated development needs, acknowledging that a holistic and long-term approach will be needed.

Domestic financing for green projects in Türkiye relies primarily on the banking sector, and it faces several barriers for green financing. The banking sector in Türkiye, which is a major part of its financial sector that has played a crucial role in the development of renewable energy generation in the country and the issuance of green bonds and mortgages, is well developed, and has taken steps towards embracing sustainable finance. However, it is facing barriers in these efforts, which

---

the CMB's Guidelines on Green Debt Instruments must be met for the green label to be assigned.

6) In 2021, total green bond issuance amounted to US$ 1.2bn in Türkiye, (US: $90bn; China: $72.2bn; Germany: $67.1bn; India: $8bn; Brazil: $2.4bn; Mexico: $0.5bn; South Africa: $0.1bn) according to the Climate Bonds Initiative. https://www.climatebonds.net/market/data/

include, among others, challenges regarding the policy environment, and limited information and institutional capacity at the sectoral level, as well as a low level of readiness to support strong green growth. Learning from Türkiye's significant success in mobilizing international climate finance in the past, and the well-developed systems for deploying it into mitigation projects, existing barriers can be removed through targeted interventions of the public sector to provide certainty over the course of action, as well as robust and reliable support for managing the risks the private sector is facing when investing in climate action. The improvement of the policy and regulatory framework to address the barriers to financing enhanced climate change and sustainability, supported by institutional capacity to develop and implement them, are fundamental prerequisites for scaling-up green investments in Türkiye. In addition, providing the banking sector with best practice guidance based on international advances in sustainability finance, including risks related to the global and domestic environmental policy, can help drive finance towards greener projects. The authorities, especially financial sector regulators including the Central Bank of The Republic Türkiye (CBRT), the Banking Regulation and Supervision Agency (BRSA), and the Capital Markets Board (CMB) could step up their recent efforts to guide financial sector players on environmental sustainability.[7]

In the aftermath of the COVID-19 and Kahramanmaraş earthquake crises, Türkiye has the potential to grow greener and benefit from embracing green growth. There is rising interest in green growth and climate action in Türkiye. Energy efficiency, nature conservation, clean energy options, and a stronger focus on the improvement of sustainability in the transport sector can be win-win areas for stimulus investments in Türkiye, if designed well. Restoring degraded forestlands and landscapes could create many jobs over the short term, while also generating net benefits from watershed protection, better crop yields, and forest products, especially regarding potential positive impacts on CO2 emissions of using forest products as structural wood compared to cement. Another area in which to create jobs and support economic recovery concerns investment in the large-scale retrofitting of buildings to make them more energy efficient, more sustainable and healthier, as well as better adapted to higher temperatures in the future. Investments in coastal resilience, climate-smart agriculture, and resilience of infrastructure to flood, drought, and precipitation changes, as well as improvements in water treatment and sanitation, waste management, and air quality, are opportunities for building the foundation of green growth, while addressing country-specific priority areas.

7) Türkiye's New Economic Reform Package (2021), the Sustainability Finance Framework of MoTF (2021), the CMB's draft Green Bond and Sukuk Guideline (2021), and the BRSA's Sustainable Banking Strategic Plan (2021). aim to diversify finance for investments that are environmentally sensitive. Especially CMB and BRSA have stepped up efforts to guide financial sector players, build capacity, and develop data and analytics, and innovative products on sustainable and green finance drawing on international best practices. The CMB's guideline is aligned with EU and ICMA standards on green bonds and sukuks.

Projects tackling post-earthquake economic recovery can help strengthen overall system resilience, and it is important that economic stimulus interventions lay the foundation for green and sustainable growth in the medium- to long-term.[8]

As a next step, Türkiye would benefit from putting in place a strategic framework for green finance. The 11th National Development Plan foresees action in several strategic areas, including developments of environmental impact assessment, strategic environmental permit, license, monitoring and audit mechanisms and capacities and strengthening of the legislation on these issues, as well as expansion of the environmental labeling system, and many initiatives to address air quality, biodiversity, and nature conservation areas on land and sea. Importantly, it also recognizes the need for improvements in the harmonization of public institutions and organizations with each other and local administrations in their powers and duties, to eliminate conflicts and to strengthen coordination and cooperation with other stakeholders in implementation. Recent announcements indicate ambitious plans at the regulatory level to boost climate action in mitigation and adaptation and address several environmental priorities. BRSA's Sustainable Banking Strategic Plan[9] was the first step by the regulator towards encouraging green banking, and efforts are underway together with the Banking Association to develop a Green and Sustainable Banking Guideline that will aim to guide banking sector players on green and sustainable finance, aligned with international best practice.[10] Other efforts by BRSA focus on preparing a Green Asset Ratio Communique and Climate Risk Management Guidelines. On the capital markets side, the team supported the Capital Markets Board (CMB) on the "Guidelines on Green Debt Instruments, Sustainable Debt Instruments, Green Lease Certificates and Sustainable Lease Certificates", published in 2022.[11] Through the Green Debt Guidelines, the CMB is encouraging the issuance of green capital market instruments. The CMB has also stepped up its efforts to build internal capacity and develop data and analytics on sustainable and green finance. Türkiye ratified the Paris Agreement in October 2021 and renamed the Ministry of Environment, Urbanization and Climate Change affirming its commitment to climate action and long-term greener growth. This will drive increased demand for green finance and a stronger role for the private sector in the future. To support the achievements of these plans and ensure the removal

8) S.Hammer, S. Hallegate and F. Banaji, World Bank, "How countries' climate ambitions can support a sustainable recovery from COVID-19," Development and a Changing Climate, May 2020.

9) https://www.bddk.org.tr/KurumHakkinda/EkGetir/19?ekId=115

10) BRSA aims to take actions based on the European Green Deal and Network for Greening the Financial System (NGFS). It joined NGFS in 2021.

11) "Green and Sustainable Guidelines" refers to the CMB's Guidelines on Green Debt Instruments, Sustainable Debt Instruments, Green Lease Certificates and Sustainable Lease Certificates" published by the CMB Board decision i-SPK 128.18 dated 24/02/2022 and numbered 10/296. https://cmb.gov.tr/data/628165661b41c617eced0ff4/c271c36f7bbd4a9429b0d503626c43d1.pdf

of persistent barriers to green investments, the key "building blocks" and areas where efforts are required include: i) enabling policies and regulatory framework, ii) institutional support and ownership, iii) data and analytics, iv) capacity building, and v) technical innovation and innovative financing approaches. Progress in these areas would support the development of a coherent strategic framework that brings various ongoing efforts together to provide a roadmap that aligns financial sector policies, regulations and incentives with the vision for pursuing green and resilient growth (See Box-1).

Box-1: Unlocking Green Finance in Türkiye:

There is increasing momentum to build a green finance ecosystem in the financial sector and government but still a holistic approach is needed. Important steps include:

- Creating an overall strategy or roadmap on green, blue, or sustainable finance would align financial sector policies, regulations, and incentives with environmental and climate goals.
- A roadmap covering both the risks and opportunities of climate change can help prioritize actions and coordinate the activities of different stakeholders, including financial and environmental policymakers, regulators, and financial institutions. It would also provide clear signals to potential investors and help create an enabling environment for increased green investment.
- Disclosure requirements and a green, blue, or sustainability-based taxonomy can foster transparency and boost public and private investment to finance the transition.
- National development banks and the Credit Guarantee Fund can be highly effective in mobilizing private finance for the green transition, including through financial innovation and de-risking instruments.
- More generally, de-risking investments by maintaining a stable macro-financial environment, and targeted guarantees and temporary cost-reducing incentives to bond issuances can play a role.
- Insurance/Pension Funds should be encouraged to make green investments.
- Risk solutions can help improve protection: Specific instruments include catastrophe bonds and/or expansion of homeowner, private and municipal asset insurance, catastrophe insurance risk pools, contingent financing, and weather-related parametric insurance.
- If blended climate finance is mobilized, municipalities could play an essential role in low-carbon, climate-resilient urban development.

Source: Türkiye Country Climate and Development Report (World Bank, 2022);
Konya Climate Council (February 2021).