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The Institute

The UBS Sustainability and Impact Institute

The green inflection point

Executive Summary

Innovate climate action – rethink, reframe, and reorganize

Is it enough to incorporate climate considerations into the investment process or should investments actively contribute toward solving the climate crisis and real-economy decarbonization?

The world is faced with clear shifts in our planet's climate system caused by excessive production of CO_2, which has already led to a warmer climate. Meanwhile, the continued degradation of natural capital, such as forests, oceans and soil, the earth's primary buffers against carbon, is adding to the problem. Decarbonizing the real-economy represents a critical challenge.

Investors and companies currently focus on decarbonization through various approaches, such as exclusion, restrictive lending policies and divesting. These approaches achieve decarbonization through portfolio alignment – investments become greener by aligning with greener objectives. But the climate does not necessarily benefit immediately.

To move the needle on decarbonization – to reduce actual greenhouse gas (GHG) emissions and help carbon intensive sectors transition faster – more can be done. in turn, this massive transition to a lower carbon economy creates opportunities for investors and asset managers who understand the complex array of crises and are willing to mobilize capital toward solutions.

In order to drive actions that measurably reduce actual carbon emissions in the environment, we need to understand the levers, complex dependencies and causalities that can drive change. It's equally important to identify and define the interconnected systems of issues and supporting innovations and initiatives that can scale across geographies and sectors to help advance decarbonization efforts more quickly.

Systems thinking focused on change
At UBS, we believe systems thinking underpins any framework related to climate change. Broad systems and framework thinking can help financial institutions to serve their clients by mapping out the system and developing theories of change.

Systems thinking

In our view, systems thinking allows us to see the big picture and understand a financial institution's role. Importantly, it can be used to identify the most impactful actions. A system is a synergy of individual components, where the whole is greater than the sum of its parts. As we discussed in the UBS Sustainability and Impact Institute's publication "From Ozone to Oxygen" climate change and biodiversity loss are essentially a system of systems failures. One way to break the chain of negative impacts is to deploy systems thinking to find solutions. By identifying key challenges and understanding their root causes, we can begin to understand how the system works.

Developing a theory of change can help clarify causal linkages and logic models that can be used to create further structure, and these frameworks can help with milestone setting, benchmarking, monitoring and accountability. Financial institutions have many levers available, including engagement, financing, investing, philanthropic activities, education and advice, that can all help to spur climate action.

Interdependencies motivate a community of actors

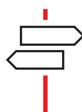
From an environmental perspective, climate change is well understood. We know what must be done to mitigate the climate crisis and already have a whole host of viable solutions at hand. But implementing these solutions at scale is challenging.

Efforts intended to speed up decarbonization should take into consideration a sophisticated web of interdependencies. We can think of climate actors as a network pyramid with governments at the top, corporations, supported by financial sector firms, in the middle and consumers, small and mid-sized enterprises (SMEs) and investors, at the bottom. To add to the complexity, these actors are located across different countries each with their own unique situations and interests in mind.

Putting this all together is key, as climate change represents an enormous challenge, but also a commercial opportunity.

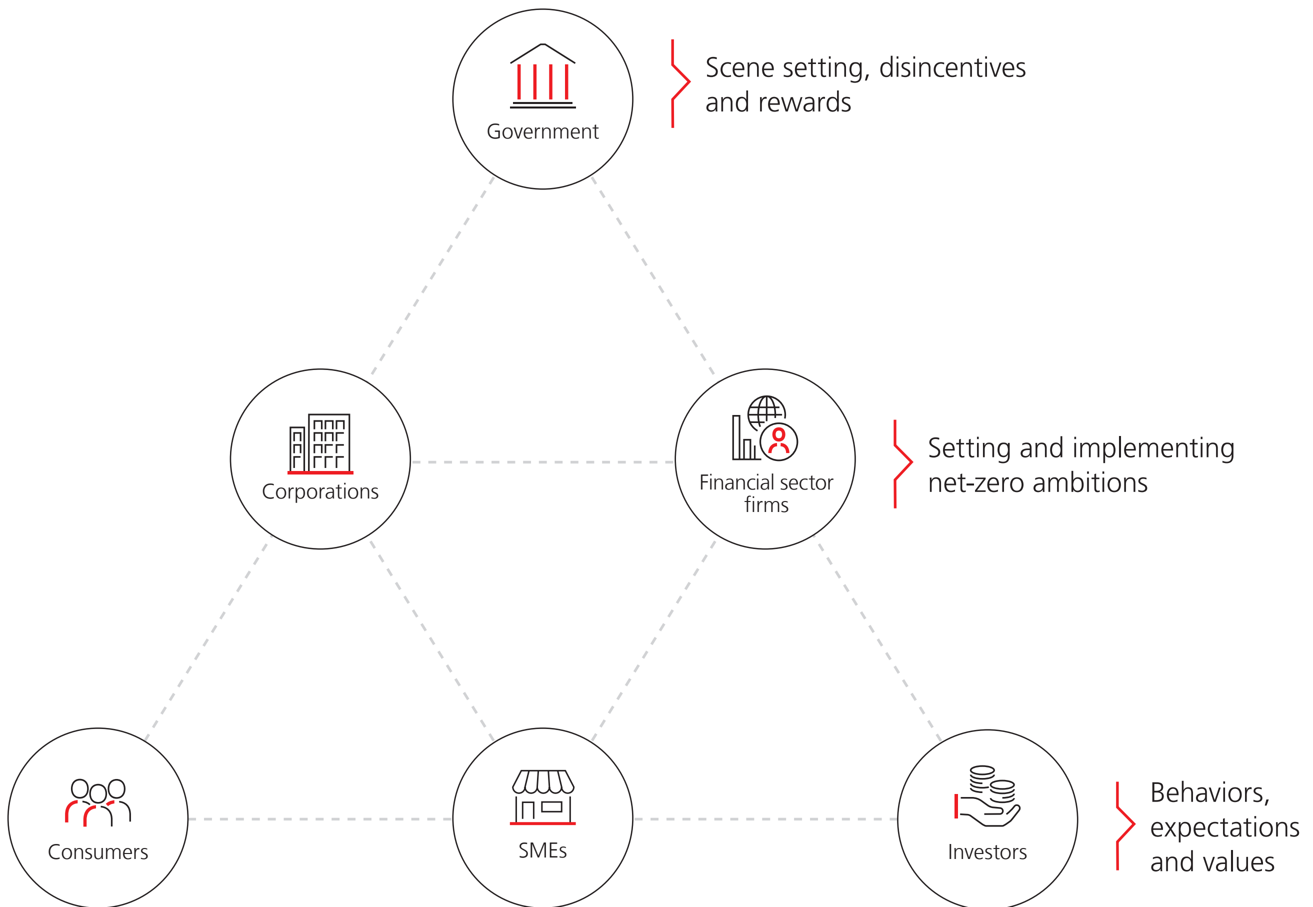
Applying a climate lens, we can consider possible investor motivations, which fall broadly into at least one of these categories:

Financial Returns
drivers of financial risks and rewards



Ethical Preferences
exposure aligned with moral values

Impact
leverage investments to make a difference



From a climate perspective, investor impact is most effective when it changes or influences a company's activities in such a way that those changes would not have happened otherwise. This requires effective investor engagement, aligned with an investment thesis, that is evidence-based and constructive in nature.

Innovative pathways unlock opportunity

There is neither a morally right nor a morally wrong approach to climate finance, only a lack of clarity or an unwillingness to commit.

Concrete climate action requires capital, and there are clear gaps in funding. In particular:

1. transition financing, where proceeds are earmarked for decarbonization of legacy businesses; and
2. scaling solutions – often by supporting early-stage private companies whose technologies effectively enable decarbonization.

Financial institutions' investing and financing functions can help address these gaps, potentially funding frontier technologies, which can be key to scaling climate solutions action.

We call them emerging or frontier technologies because they are generally in early development, possibly even in demonstration or prototype phases. Innovative financial structures can help to catalyze capital flows toward these vital emerging technologies and support them until they are cost competitive.

Blended finance, which combines an initial investment, often from a philanthropic or government entity, with subsequent commercial investment can be a catalyst that helps to accelerate financing for emerging and frontier green technologies.

Blended finance can meet many objectives

Government incentives are vital to curating capital investments, particularly into emerging technologies that can help scale the climate transition, and into emitters that need to invest in cleaner ways of delivering high emission materials that will continue to be necessary to society – think cement for example.

Blended capital initiatives, tax breaks, subsidies here and other tools have found a permanent place in climate investing and often provide the much-needed confidence and first-loss provisions that essentially motivate private capital to take part. These incentives can aid in driving seed capital to aid tech start-ups.

Moreover, there are opportunities to support larger corporate customers through off-balance sheet financing options such as special purpose vehicle (SPV) structures, also known as limited partnerships, and/or via the support of state guarantees. These structures could be set up to test and implement innovative technologies and help to identify new directions for parent companies in high emission industries.

Lastly, philanthropic activities can also help scale solutions to key implementation challenges, notably:

1. risk transfer
2. mitigation of time to economic viability gap

For the required scale of addressing the climate crisis, solutions will eventually need

to come from channeling capital and building partnerships around market-based solutions, i.e., those that succeed or fail because of the natural forces of the free market.

This is not to say that sustainable and impact investing can, or ever should, replace government spending or philanthropy.

Not-for-profit capital may be most efficiently deployed for goals relating to public goods or those where establishing market-clearing price mechanisms for externality costs is difficult.

But a private capital transition framework within an approach to climate change will allow banks to support high-polluting sectors with their transitions.

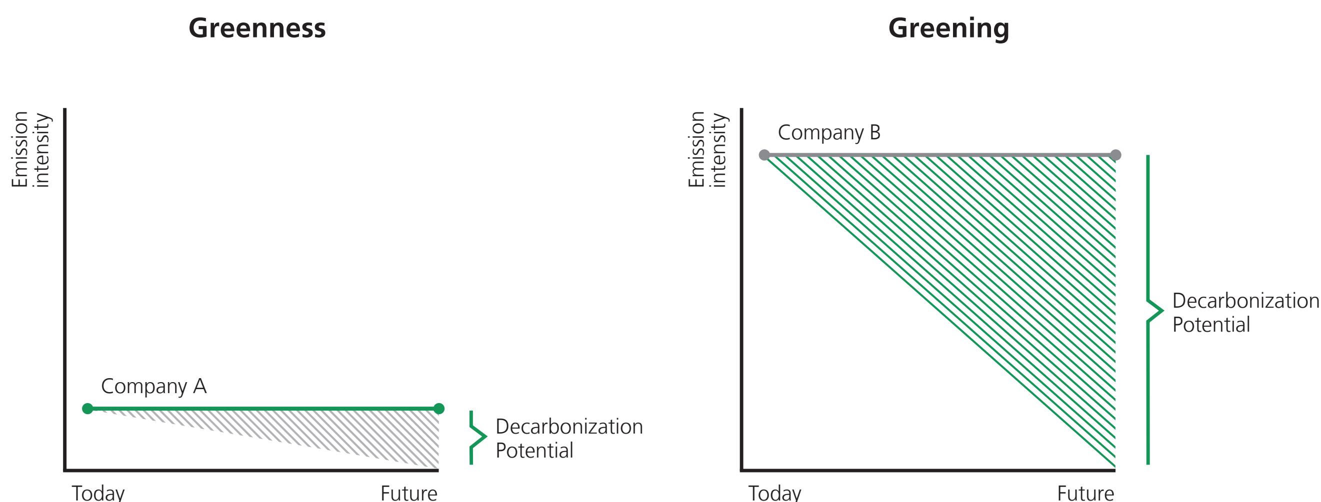
Evolving our investing mindset to real-economy decarbonization

Another piece of the puzzle is moving away from only considering historical levels of emissions, and focusing on future rate of change. This promotes a fundamentally different approach to both climate investing and financing:

- Treating improvement potential as an opportunity will enable financial institutions to engage with emission-intensive sectors where decarbonization efforts matter the most.
- Future change, as a metric, is better aligned with an impact mindset, encouraging innovation and real-world change.

And, we know that what gets measured, gets managed.

Invest for Greenness or Greening



This stylized illustration suggests the difference between investing in a low emission-intensity company with limited decarbonization potential (Company A) and a high emission-intensity company with ample decarbonization potential (Company B). With a low carbon portfolio footprint focus investors are incentivized to invest in Company A. With a rate of change focus investors are incentivized to invest in Company B.

To speed up action on climate finance, it will be important to apply an additional transition lens to bank lending and finance facilitation.

It's easy to understand why climate change dominates sustainable investing: the climate crisis is the most urgent threat of our time and requires multiple levels of engagement and action across sectors. But it's important to understand why financing the climate transition is essential.

For some companies minor adjustments to operating models and indirect actions will suffice for them to achieve their decarbonization goals. But others will need to reinvent their businesses completely. And some will make solving the climate crisis their primary business focus. This will require innovative ways of deploying and accounting for capital.

We believe there is an opportunity for investors to have a measurable impact and play a more meaningful role in tackling climate change. We suggest that greater clarity and broader understanding around investment product objectives will help drive capital toward impact offerings.

Advising can guide the transition journey

Understanding why investors choose a climate lens and developing better aligned metrics are two sides of the same coin. What we also should consider is which solutions we believe will most effectively facilitate decarbonization and what needs to be done to facilitate investments in them.

Advisors are often the first point of contact and education for clients regarding the sustainable options available, the outlook for emerging technologies and the opportunities to support scaling low-carbon solutions.

Three key actions are important for advisors to move the needle on the low-carbon transition

- create innovative financial instruments
- recognize the financial value of green investments
- establish climate-transition task forces

Over time, as awareness about sustainable finance becomes more widespread, we believe that investors will expect more detailed green CAPEX disclosures from companies, and that they will openly question when investment levels are too low. In return, we expect markets to pay higher green valuation premiums.

Corporate valuation frameworks and investor education efforts can include several elements, including:

- abatement technologies
- green CAPEX and OPEX
- carbon tax
- customer dynamics
- green valuation premium

We are already seeing companies across different sectors making decisions based on company - and location-specific marginal abatement cost curves (MACCs) and internal assumptions on future carbon pricing. MACCs are helpful visualizations of decarbonization pathways showing how technologies compare by cost and CO_2 abatement potential.

Looking forward

The low-carbon transition will take place at different speeds across sectors and locations. Financial institutions and banks need to understand these dynamics and idiosyncrasies to be better positioned to advise their clients about the risks and opportunities related to both climate change and working toward the solution.

By working closely with their clients and industry peers in a symbiotic partnership financial advisors can influence and encourage the adoption of more sustainable practices and improved data disclosure requirements, which in turn can help to identify those companies and industries which are most integral to climate change and how to invest in them.

The first steps have been taken toward decarbonization across industries and regions. Many companies, investors, asset managers and financial sector firms servicing them recognize the value in transitioning toward a collective net-zero future. Initiatives and collaborations have started to shape norms that will help guide meaningful actions.

The next steps in climate financing present an opportunity and imperative to effect real progress in not only transitioning away from emission-intensive sectors, but in working in partnership with all stakeholders to green the economy and help pollutive industries successfully make their own transitions.

The risks linked to inaction and a "business as usual" approach are both known and evolving in unpredictable ways. When we expand our focus to greening the future, enabling green solutions and models to take hold, augmenting exclusionary and divesting approaches, educating ourselves and our clients, the potential for real, measurable, positive impact increases as does the investment opportunity set.

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