

Why isn't Canada investing enough in green projects, despite ambitious climate targets?

August 16, 2021

The Insights:

- Awash in green capital, Canada isn't undertaking enough green projects to broadly change its emissions profile.
- A key problem: large-scale projects that could create meaningful change, for instance in heavy-emitting sectors, are often costly, come with higher investment risk, and don't provide significant near-term financial returns.
- With a relatively large share of industrial emissions, including from the oil patch, Canada faces a challenge in ensuring that sustainable finance reaches all parts of its economy.
- Boosting near-term financial returns from the most challenging projects could help attract more investment.

The Stakes:

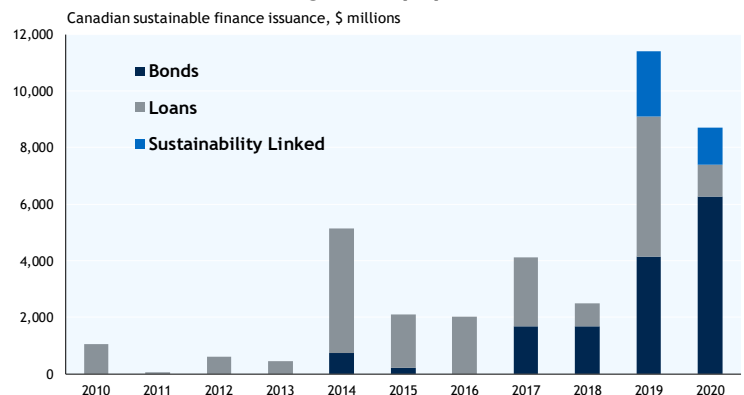
It could cost Canada \$70 billion a year to meet its net zero commitments. The country's financial sector could play a critical role in accelerating those efforts—if able to expand sustainable finance beyond current investment of \$10 billion a year.

The Context:

It's never been easier for firms to access capital for projects that advance environmental goals. Global green bond issuance by businesses has grown more than tenfold since 2010, to USD \$290 billion in 2020. Canadian firms alone raised C\$38 billion in green financing over that period.

Global policy efforts have focused on attracting investors to the space by setting out standards on what kinds of investments qualify for the "green" label. In 2020, the EU published a list of activities it considers sustainable, a key foundation for European financiers. Efforts are likely to accelerate ahead of November's UN climate conference. Canada has struck a Sustainable Finance Action Council. But despite leadership on carbon pricing, Canada is devoting less effort to sustainable finance than its European peers—as a share of GDP, it funds half as many green projects—in part because there's less policy clarity from Ottawa. Growing commitments by the U.S. and China will likely start to accelerate their green finance efforts, too, meaning Canada could fall even further behind.

Once dominated by loans, standards mean green bonds are becoming more popular



Source: Bloomberg, RBC Economics

Our Analysis:

The push for faster green finance has led markets to prioritize project-based funding, such as financing an existing factory's effort to reduce emissions. Financing the broader transitions needed to reduce emissions in upstream oil and gas production and the manufacturing of cement and steel is proving more challenging—an especially big problem for Canada with its relatively large share of industrial emissions.

Canada faces two key hurdles to deploying sustainable finance on the scale needed to get to net zero.

For one, few emissions-reduction projects generate sizeable, near- to medium-term financial returns. (Building retrofits, among the least controversial of climate actions, can take 20-plus years to reach positive cash flows.) That's a problem in attracting investors.

The projects that do provide nearer-term returns, like renewable power (where returns from selling electricity generated with no fuel costs are beginning to rival or outpace traditional power plants), are already being funded. Three-quarters of Canada's existing green finance has gone to renewables projects. Net zero investments elsewhere tend to be expensive, and don't generate the same kind of cash flows or returns without regulatory support (like tax credits or carbon pricing).

Unlike renewables, many industrial processes can't yet get rid of fossil fuels entirely (e.g. processes that require very high heat). That's not to say projects that cut fuel use won't reduce emissions; they just may not produce strong near-term financial rewards. Canada will need to attract investors with greater risk appetite, and those willing to wait longer to get their initial investment back, to help fund this slice of the transition. It should ensure that rules for green and sustainable finance allow for these projects to be labelled as such, so emissions-intensive sectors can access the capital they need to transition.

Markets have created a potential solution—"sustainability-linked" finance—which allows issuers to set organization-wide targets, like overall emissions cuts, and pay lower interest rates if they're met. But thus far, funding in this space has been limited.

One way to entice shorter-term investors would be to pull forward the returns of long-term projects like building retrofits and industrial energy-efficiency measures, for example by charging lower utility rates to entities that cut emissions.

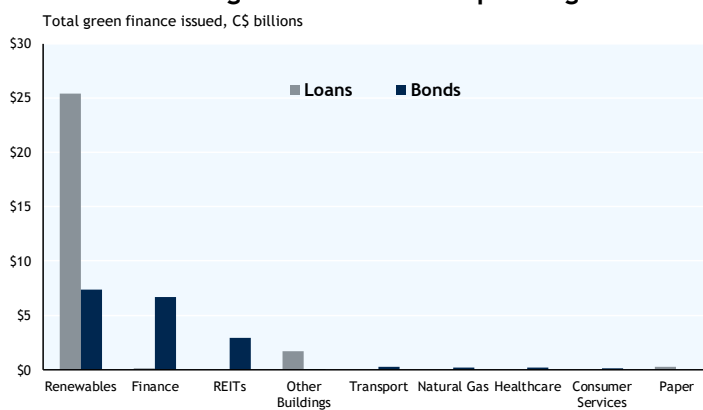
The second hurdle is that some projects are economically challenged even over the long term, unless policy support plays a significant role. Direct subsidies or contracts that provide certainty on the future carbon price can help generate returns where none exist today (the latter reduce the risk that carbon price savings change in the future).

That could make investing in emissions-saving technologies more attractive as businesses allocate their existing capital budgets. There's lots of money for general business investment—since 2015, investment in engineering structures and industrial equipment averaged nearly C\$120 billion annually, and corporate after-tax profits add another \$130 billion—so boosting incentives to invest in clean rather than traditional projects could help unlock emissions cuts, reducing the need to use public dollars or incentivize risk capital.

The Road Ahead:

Canada is on a path to outlining how firms will be required to disclose climate risks, how banks will need to manage them, and which activities are sustainable and aligned with its climate goals. But in isolation, even the best-designed disclosure, risk manage-

Green financing is limited outside power generation



Source: Bloomberg, RBC Economics. Data as of July 23, 2021.

ment, and labelling rules won't encourage enough more businesses to invest in emissions cuts. In crafting sustainable finance policy that will help Canada meet its climate goals, governments will also need to make sure the right investors are matched up with companies and the right incentives are in place to encourage abatement.

Glossary:

Green finance: bonds and loans where the funds are earmarked for funding or refinancing a green project, such as renewable power, low carbon transportation, energy efficiency, and recycling.

Sustainable finance: a broader class of bonds and loans aimed at improving environmental, social, and governance issues. They can be project-oriented like green finance, but may not need to be. Those that aren't are called "sustainability-linked."