HIGH MEADOWS
INSTITUTE

Sustainability in Capital Markets

Financing the transition to a sustainable low-carbon economy

Introduction

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Sustainable finance is at a critical juncture and faces an uncertain future. On the positive side, sustainability-focused investments and finance initiatives have grown dramatically over the past decade, as have commitments to ambitious climate goals by leading public and private market investors. A plethora of standards, frameworks and tools have been developed to guide investors and other financial market actors in their decision-making, helping to accelerate the flow of capital towards climate solutions and streamlining the collection and reporting of climate-related data.

But despite this progress, the level of investment and support for the transition to a sustainable low-carbon economy (SLCE) remains well short of what is needed among financial market participants.

The latest data shows just how big of a financing gap there is to fill if the world is to meet its climate goals and thereby minimize the systemic risk presented by climate change. For example, while the International Energy Agency (IEA) estimates that more than $1.7 trillion was invested in clean energy in 2023, the Climate Policy Initiative puts the total estimated climate finance need at $8 trillion a year today, rising to $10 trillion a year after 2030. The United Nations Environment Programme (UNEP) estimates that countries may need to spend up to $387 billion annually on climate adaptation by 2030. In an October 2024 report, Goldman Sachs estimated that $300 trillion of investment will be needed through 2050 to meet net-zero goals, with 70% of total financing dependent on the contributions of the private sector.

There are several reasons for the gap between the current levels of commitment among financial market actors and what is needed to avoid the worst effects of climate change. These reasons include a lack of understanding of the economic downside risk that unchecked climate change represents, a confusing regulatory and policy environment, conflicting client demands, and misaligned incentive structures.

Some of these headwinds will be easier to address than others. But the reality remains that the lack of climate financing and action has put the world on a trajectory for 2.5-3 degrees of warming by 2050, a scenario that could slice 10-15% off of global GDP and lead to the displacement of as much as a third of the global population.

Until recently, many of the world's governments were expected to take the lead in driving financial sector support for the climate transition by creating incentives and mechanisms to catalyze investment flows, as demonstrated by the Inflation Reduction Act in the U.S. However, with the recent resurgence of populism globally—and in the U.S. in particular—it is increasingly evident that near-term government leadership for the SLCE transition will be hard to come by. In fact, in the U.S., home to the world's largest and most sophisticated capital markets, we are witnessing the rise of a virulent anti-ESG political movement, alongside executive actions by the new administration to withdraw support from the Paris Climate Accord and to roll back policies aimed at fostering private sector investment in climate solutions.

Given the uncertain role of governments, the critical question now is: What can key market actors do to accelerate financial sector support and investment in climate change mitigation and adaptation? This involves both direct actions—such as financial innovations that de-risk and accelerate investment in climate ventures—and indirect efforts, including more robust investment stewardship and policy advocacy. As the climate crisis intensifies, there is an urgent need to address these challenges and engage all market actors in enhancing the financial sector's support for the transition to an SLCE.

HMI's Sustainability in Capital Markets program is exploring this imperative in two phases.

Phase One: Assessing Current Engagement

In the first phase of the project, HMI's *Sustainability in Capital Markets Report 2025,* we are stepping back to examine how key actors across the capital market system, including both public and private market actors, are responding to the climate challenge. Much of the focus to date has been on public equity markets, leaving significant gaps in our understanding of the credit market system—the largest component of capital markets—as well as the rapidly growing private equity and private debt markets and their intermediaries.

The goal of this phase is to gain deeper insights into the roles these investors and institutions currently play within the broader financial system when addressing climate change and to evaluate their potential to do more. The report will assess the current commitments and perspectives of key actors within the financial and capital market ecosystem in supporting the SLCE transition.

Key questions guiding this assessment include:

- Who are the established and emerging players in the capital market system?
- How do leading firms within key sectors of the financial markets currently view the climate change challenge and their role in addressing it?
- What strategies and approaches do these firms and the sector they are part of most frequently use in addressing the climate challenge?

Phase Two: Driving Collaboration and Action

Beginning in mid-2025, the second phase will build upon the insights from our analysis. In collaboration with relevant industry partners, this phase will explore opportunities to enhance the financial sector's support for the SLCE transition. The focus will be on fostering greater and more constructive collaboration among players within the capital market system and between private and public financial sectors.

By engaging with market actors, identifying gaps, and fostering innovative solutions, HMI aims to address the pressing need for increased financial sector participation in the transition to a sustainable, low-carbon future.

Key questions guiding this exploration include:

- What **incentives** are necessary to motivate greater capital market support for the SLCE transition?
- What **financial sector innovations** can encourage greater private sector investment in an SLCE through mechanisms like blended and concessional finance?

The Financing Gap

The good news is that commitments from the financial sector are growing, with private actors providing 49% of total climate finance ($625 billion) in 2022. New announcements seem to emerge monthly, celebrating record-breaking amounts of sustainability-themed investments:

- **Sustainable Investments Surpass $30 Trillion:** According to the Global Sustainable Investment Review (GSIR), assets under management (AUM) in sustainable investments exceeded $30 trillion in 2022.
- **Rise in Sustainable Bond Issuances:** According to the Climate Bonds Initiative, $272.7 billion in aligned green, social, sustainability, and sustainability-linked bonds (GSS+) was added in the first quarter of 2024, 15% more than in the first quarter of 2023. This brought the cumulative volume of GSS+ deals to $4.7 trillion, with green bonds alone surpassing $3 trillion.
- **Impact Investing Growth:** The Global Impact Investing Network (GIIN)'s 2024 *Sizing the Impact Market* report estimated the size of the global impact investing market to be $1.571 trillion and growing rapidly.

However, despite these impressive figures, flows continued to fall short of needs, particularly in emerging markets and developing economies (EMDEs). The IEA estimates that emerging markets alone will need more than $2 trillion annually by 2030, primarily in the energy sector. According to the International Monetary Fund (IMF), however, EMDEs receive only about $770 billion in clean energy investments each year, with much of this total going to just a handful of large economies like China, India and Brazil. As the Climate Policy Initiative noted in its 2023 report, only $30 billion, less than 3% of total climate finance globally, went to or within the least developed countries, while 15% went to or within EMDEs (excluding China). The 10 countries most affected by climate change between 2000 and 2019 received just $23 billion, less than 2% of the global total.

Current Strategies for Supporting the SLCE Transition

Over the last two decades, the sustainable finance industry has introduced numerous strategies to attempt to address the financing gap and accelerate the SLCE transition, each with its unique advantages and limitations. A few of the most prominent ones currently include:

- **Divestment / Exclusion:** This strategy focuses on limiting investment in 'non-sustainable' companies and industries (e.g., fossil fuels). This approach was the foundation for the socially responsible investment movement in its early stages and is still an integral part of many sustainable investing strategies. However, there are questions about its potential for delivering positive real-world outcomes.
- **ESG Integration:** This involves incorporating environmental, social and governance (ESG) factors into investment analysis and decision-making, primarily from a risk management perspective. This is one of the most widely adopted strategies currently deployed by investors and financial institutions.
- **Shareholder Engagement / Active Ownership:** This approach involves engaging with companies, either through public engagement in the form of shareholder resolutions and proxy votes or private engagement in the form of dialogues with company management, with the intention of improving corporate behavior on specific ESG issues. The idea of active ownership, or investment stewardship, can be an important part of an investor's toolkit and is often seen as a complement to other strategies.
- **Impact Investing:** This approach aims to generate positive social and/or environmental impacts alongside financial returns. However, many impact investors still face questions about their ability to balance financial and impact performance, leading to confusion among investors and inefficiencies in capital allocation.
- **System-level Investing:** This is an emerging investment approach centered on adapting both existing, conventional investment techniques and utilizing new tools to manage the risks and rewards of the social, environmental, and financial systems. Recognizing the many linkages between capital markets, the economy, and other macrosystems through which capital markets derive value creation, the objective of this approach is to provide a stable, resilient foundation for investment management across all asset classes. However, as an emerging investment strategy, it currently lacks clear metrics and frameworks that would be needed for reliable benchmarking and assessment.

Despite the rapid growth of sustainable finance, these strategies have not achieved the transformative impact needed to avoid the worst effects of climate change.

Challenges to Accelerating an SLCE

Four key challenges stand out that will need to be addressed if we are to accelerate progress and meet the SLCE transition imperative.

The Mindset Challenge

Mobilizing greater financial sector support for the SLCE transition requires a fundamental shift in mindset. Financial leaders must recognize not only the critical role their industry plays in supporting this transition but also the long-term investment opportunities that arise from moving away from an extractive economic model toward a regenerative one.

This shift also demands an acknowledgment that systemic environmental and social challenges cannot be addressed by governments alone—they are either exacerbated or mitigated by the behavior of the financial system itself. However, only a handful of financial leaders have fully embraced this perspective and incorporated it into a comprehensive approach that both advances the SLCE transition and delivers competitive financial returns. Without broader adoption of this mindset, progress will remain limited.

The Incentive Challenge

A shift in mindset is unlikely to happen at scale without proper incentive alignment. Historically, financial markets have prioritized profit maximization within an acceptable level of financial risk, with systemic risks—such as climate change—largely treated as externalities outside the scope of financial decision-making.

Over the past decade, mainstream investors have begun integrating sustainability factors into long-term risk management and business strategy rather than treating them as mere branding tools. However, for capital to flow meaningfully toward SLCE-oriented investments, financial incentives must evolve to balance economic priorities with sustainability imperatives. This includes pricing both positive and negative externalities into investment decisions to ensure that sustainability considerations are not just optional but integral to financial market operations.

The Regulatory and Standards Challenge

Effective public policy and regulation are essential components of the incentive structures needed to drive sustainable finance. In recent years, government policies in the U.S. (e.g., Inflation Reduction Act) and Europe (e.g., Sustainable Finance Disclosure Regulation, or SFDR), as well as in other jurisdictions, have taken steps to integrate sustainability into financial markets. These policies range from catalyzing investment in clean energy to establishing transparency standards for sustainable finance. However, such policy signals remain fragmented, with varying levels of ambition and enforcement across jurisdictions, often creating confusion rather than clarity.

Moreover, with the election of a U.S. president strongly opposed to the integration of sustainability factors into financial markets, the prospect of developing a globally coherent public policy framework for sustainable finance appears uncertain in the short to medium term.

In the absence of robust governmental leadership, the past few decades have seen a proliferation of voluntary industry and civil society initiatives aimed at setting sustainability goals and disclosure standards. These range from initiatives that establish SLCE commitments (e.g., Climate Action 100+) to those defining sustainability reporting frameworks (e.g., TCFD and ISSB). However, this landscape is increasingly crowded, with overlapping and sometimes conflicting standards leading to confusion and fatigue among market participants. While recent efforts to consolidate frameworks (e.g., the ISSB's unification of reporting standards) represent progress, further harmonization is needed to create a credible and coherent structure for sustainable finance.

The Accountability Challenge

A weak regulatory environment in most jurisdictions, combined with the predominance of voluntary reporting, allows financial institutions to make sustainability-related claims without necessarily following through on their commitments. The UNEP Finance Initiative's 2023 report on banking and insurance climate commitments, for example, found that fewer than 40% of financial institutions had integrated climate risks into their balance sheets.

Compounding this issue, the rise of anti-ESG political movements—especially in the U.S.—has led many financial institutions to withdraw from climate-focused initiatives or scale back their commitments. As a result, strengthening transparency and accountability mechanisms in financial markets is becoming increasingly difficult.

In the near term, one of the most significant advances in accountability is the EU's SFDR, which requires financial institutions to disclose how sustainability risks are integrated into investment decisions. However, it does not mandate commitments to specific SLCE transition targets, leaving significant gaps in enforceability.

In the absence of strong government leadership, the responsibility for addressing these four challenges increasingly falls on private sector leaders in finance, alongside their civil society partners. Without a concerted effort to shift mindsets, align incentives, clarify regulatory frameworks, and strengthen accountability, the financial sector will continue to fall short of its potential in driving the SLCE transition. However, those institutions that proactively address these challenges will be better positioned to thrive in an economy that is inevitably transitioning toward sustainability.

Sharing Our Findings

Starting in early 2025, HMI will release sector profiles that provide snapshots of the key capital market players' unique roles in the SLCE transition. These findings will be discussed in investor forums convened by HMI and our partners throughout 2025, with the aim of identifying specific opportunities and actions to strengthen the financial sector's contributions to the SLCE transition.

Next Steps

Sector Profiles: HMI will present snapshots of how the financial sector's key actors currently approach the SLCE transition using a custom-built framework that relies on a tiered categorization system of SLCE 1.0, SLCE 2.0, and SLCE 3.0. This framework builds on existing research and provides a high-level overview of the current state of support for the SLCE transition, thereby highlighting potential areas for innovation and experimentation (see the Methodology section for a more detailed explanation):

- **SLCE 1.0:** SLCE-related factors are viewed as non-material, with organizations engaging in sustainability primarily on a minimal or voluntary basis. There is little recognition of SLCE factors as integral to value creation or financial performance.
- **SLCE 2.0:** SLCE-related factors are recognized as financially material, with organizations integrating sustainability into core strategies primarily to manage financial risks and capitalize on opportunities.
- **SLCE 3.0:** SLCE-related factors are considered material to both financial performance and broader social, environmental, and economic stability. Organizations manage these factors at both business and systemic levels, aligning with global sustainability frameworks and focusing on double materiality to drive systemic change.

This assessment will look at various actors such as asset owners and managers (e.g., pension funds, sovereign wealth funds), market intermediaries (e.g., investment consultants, investment banks), and more.

Some sector snapshots will also include an in-depth case study on a leader in the SLCE transition, examining the drivers and incentives that drove these firms to take a leadership position, how their strategy evolved, and how they operationalized and executed the strategy to achieve success.

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Introduction

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