Four Public Policy Avenues for Scaling Up Sustainable Finance in Brazil

Author

2 Degrees Investing Initiative France

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Sustainable finance OBSERVATORY | formerly 2° investing initiative

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Brazil has displayed broad engagement of the financial community when it comes to green finance initiatives.

In 2014, the Central Bank of Brazil (BCB) became one of the firsts to adopt guidelines with regard to environmental and social responsibility of financial institutions. It is the only central bank in the Americas that has regulations or supervisory expectations regarding ESG matters[1]. In 2020, it launched its *agenda sustentavel* (sustainability agenda). This agenda aims at promoting sustainable finance and sustainability risk management within regulated institutions and incorporate sustainability variables within the BCB decision making process. Along with greening its own portfolio management, such as its international reserves management, it is exploring the idea of implementing a "green liquidity facility" which would accept green collaterals at preferential terms in refinancing operations.

The private sector also engaged into green finance independently. As early as in 2004, Itau Unibanco marketed a fund focusing on social and environmental outcomes. FEBRABAN, the main banking federation of Brazil, released a Green Bond guide in 2016 and guidelines for voluntary implementation of the TCFD in 2018[2].

However, the numerous initiatives on green finance in Brazil are still insufficient to foster an alignment of capital flows with a less than 2°C global warming. The **recent PACTA assessment of the Brazilian fund industry** implemented by RMI shows that capital allocation of the Brazilian funds industry is not aligned with a less than 2°C scenario such as the Sustainable Development Scenario of the International Energy Agency. The PACTA tool allows to assess whether financial portfolios are aligned with different climate transition scenarios. Its application to the Brazilian funds industry showed that fossil extraction (coal, oil, gas) of companies in portfolios (equity, bonds) of Brazilian funds is expected to keep increasing until 2026, while it should decrease to be aligned with a less than 2°C scenario. Power generation companies in portfolios of Brazilian funds is not either expected to be aligned with such a scenario by 2026, except, to some extent, hydro-based power. When it comes to vehicles production, companies in portfolios of Brazilian funds are expected to increase significantly electric vehicles production in a way compatible with this scenario, but Internal Combustion Engine vehicles production will also increase significantly above what it should to be compliant with a less than 2°C scenario.

"The numerous initiatives on green finance in Brazil are still insufficient to foster an alignment of capital flows with a less than 2°C global warming"

This policy brief takes stock of the results of the PACTA analysis of the Brazilian fund industry. They show an urgent need to accelerate the greening of capital flows – which entails to reduce financial flows directed towards high-carbon companies and enhance capital flows directed towards low-carbon production. This calls for strengthened regulations and ambitious policies to be implemented by Brazilian regulators, central bank and

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[1] WWF, 2021 SUSREG Annual report – A baseline assessment of sustainable financial regulations and central bank activities, 2021, available at https://www.susreg.org/WWF_SUSREG_Annual_Report_2021_FINAL_UPDATED.pdf

[2] Banco Central do Brasil, BC# Sustainability, 2020, available at https://www.bcb.gov.br/content/about/presentationstexts/BCB_Agenda_BChashtag_Sustainability_Dimension_Sep2020.pdf

government. This policy brief aims at putting forward policy ideas for Brazilian policy stakeholders to advance further the sustainable finance agenda in the country, focusing on climate-related aspects.

1. Strengthening transparency along the green finance value chain

Defining what is green and what is not is key to advance a green finance agenda. The absence of a framework common to the financial industry to identify green and non-green investments leaves wide open the fragmentation of the market and the possibility of greenwashing, *i.e.* false promises regarding the climate impact of an investment product or a fund. In Brazil, a high number of companies report on their green activities or investments in a selective manner due to the lack of harmonized definition of what can be considered green[3]. The supply of investment funds with green assets is minimal and hampered by the lack of a common definition[4].

A. Developing a taxonomy of green and non-green activities

A taxonomy precisely aims at providing a common definition of what is green for financial and non-financial corporates. There are several initiatives in Brazil aimed at identifying and classifying activities that can be deemed sustainable. For instance, SITAWi and the *Instituto Clima e Sociedade* launched in 2018 an initiative classifying 104 activities and technologies as green and eligible to be financed through green bonds. Several ministries (the Ministry of Agriculture, Livestock and Food Supply; Ministry of Infrastructure; Ministry of Regional Development) partnered with the Climate Bonds Initiative to incorporate climate criteria into their projects' portfolios.

The government should build on these initiatives– and others[5] - to develop a taxonomy in Brazil. This has already been proposed in several reports[6]. Other proposals however only focus on developing a taxonomy of green activities. Along with this, the Brazilian government should consider developing a taxonomy of non-green activities taking place on its territory. The low-carbon transition indeed entails to strongly develop green activities, but, more importantly, to wind down high-carbon practices and sectors. The recent PACTA analysis of RMI shows the importance of being able to track the alignment of high-carbon activities with selected transition scenarios, to ensure their wind down is happening at the right pace. It enables to know what types of policies should be implemented to different sectors (for instance,

"The Brazilian government should consider developing a taxonomy of non-green activities"

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[3] Knoch et al. 2022. O mercado de financas sustentáveis no Brasil em 2022, GIZ, available at https://labinovacaofinanceira.com/wp-content/uploads/2022/03/FiBraS-Mercado-FinSustentaveis_2022.pdf

[4] Ibid.

[5] See Ricas and Baccas. 2021. Taxonomia em Finanças Sustentáveis: panorama e realidade nacional, GIZ and LAB, available at https://www.labinovacaofinanceira.com/wp-content/uploads/2021/04/Taxonomia-em-finan%C3%A7as-sustent%C3%A1veis-Panorama-e-Realidade-Nacional.pdf

[6] See for instance Ricas and Baccas (2021) and Knoch et al. (2022)

ambitious and directional policies for strongly misaligned high-carbon activities, subsidies for decarbonising high-carbon misaligned activities…). It would also help the market develop financial instruments for financing the transition of high-carbon activities.

Developing a taxonomy is a long process which should therefore be started as early as possible. The government could endow the *Laboratório de Inovação Financeira* (the LAB) – a multi-stakeholder body aimed at developing research and dialogue on sustainable finance innovations - with a mission to conduct a preliminary study of the best options for the country to develop a taxonomy[7]. It should highlight the challenges and opportunities associated with the development of a taxonomy and outline the various options the country has to developing a taxonomy of green and non-green activities.

B. Providing a framework for second-party opinions on investment products

Ensuring the green character of investment products also requires robust second-party opinions. Second-party opinions are assessments conducted by independent organisations such as credit rating agencies to assess the green social or sustainable characteristics of an investment product. Independent and qualitative second-party opinions are essential to ensure transparency regarding the green or non-green character of underlying activities funded by an investment product.

In Brazil, second party opinions are "still in their infancy"[8]. There has been critics regarding the complacency of several second-party opinions with regard to the companies analysed[9], and methodologies used are strongly heterogeneous. Moreover, there is no legal requirements for marketing an investment product as green or sustainable, leaving an autoregulation of the market which blurs the real contribution to the low-carbon transition of products marketed as green or sustainable.

The regulator – CVM (*Comissão de Valores Mobiliários*) - should step in to provide more clarity in this market. It should promote a common framework for second-party analyses to ensure they abide by a minimum set of criteria ensuring the quality of their analyses and fostering convergence of analyses. CVM should require second-party opinion businesses to be trained on such an analytical framework to ensure its take up by market actors. Once a taxonomy is developed, which can take several

"The CVM should promote a common framework for second-party analyses to ensure they abide by a minimum set of criteria ensuring the quality of their analyses"

[7] As has been proposed by Ricas and Baccas (2021)

[8] Ibid.

[9] See for instance, Reset, JGP alerta sobre selos verdes e põe impacto na ponta do lápis em fundo de crédito ESG, 2021, available at https://www.capitalreset.com/jgp-alerta-sobre-selos-verdes-e-poe-impacto-na-ponta-do-lapis-em-fundo-de-credito-esg/

years, it should constitute the basis for second party opinion businesses to assess the sustainability characteristics of an investment product.

2. Mainstreaming climate action in financial institutions through individual and institutional capacity

Climate-related actions by financial institutions is strongly dependent upon the knowledge and internalisation of the topic by financial institutions. It requires capacity, both in terms of the ability of the internal structure to put sustainability at the center of its day-to-day management practices and in terms of ability of staff to understand and take the right decisions on this topic.

The regulator, CVM, should include in its supervisory requirements the need for financial institutions staff to have a minimum knowledge of the topic. The NGFS highlights the need for better training of financial institutions staff[10]. The CVM should adopt expectations with regard to the sustainability-related knowledge that financial institutions should have. Training could be delivered via the CVM, potentially with the help of the LAB. The CVM could propose a sustainability or ESG certification to incentivize training.
In this endeavour, specific attention should be given to the level of sustainability-related knowledge of high-level financial institutions staff. Knowledge of the topic is too much circumscribed to specific teams dedicated to ESG or CSR topics, while it should strongly inform financial institutions' strategies. The certification proposed above could be made compulsory for high-level staff, ensuring minimum understanding by these employees which are key to a financial institution contribution to the low-carbon transition.

Knowledge is a key aspect for fostering the incorporation of sustainability-related matters into a financial institution strategy but cannot guarantee the effective take up of this topic by high-ranking staff. The CVM could therefore make compulsory to designate a board member responsible for the oversight of sustainability-related topics.

"The CVM could make compulsory to designate a board member responsible for the oversight of sustainability-related topics"

[10] NGFS. 2019. A call for action - Climate change as a source of financial risk (first comprehensive report), 2019, available at https://www.ngfs.net/sites/default/files/medias/documents/ngfs_first_comprehensive_report_-_17042019_0.pdf

3. Using tax incentives to foster an alignment of capital flows with the low-carbon transition

When it comes to climate-related sustainability, tax incentives usually focus on non-financial companies and leave aside the taxation of financial institutions[11]. Nonetheless, carbon-related tax incentives or penalties can alter the risk-reward profile of high-carbon and low-carbon investments and therefore constitute a relevant policy option for aligning financial flows with the low-carbon transition.

There are already in Brazil a few tax incentives related to the financing of green infrastructures. In 2020, the government released the decree n°10,387. It extended tax benefits for the issuance of infrastructure obligations to projects related to low-carbon urban mobility, low-carbon electricity generation, basic sanitation and projects in isolated urban areas[12]. It also simplified the administrative procedures for such projects[13].

The logic of providing tax exemptions on low-carbon projects obligations could be extended to the taxation of dividends disbursed by low-carbon companies. In 2021, the Brazilian House of Representatives introduced a Withholding Income Tax (WHT) on dividends paid by Brazilian companies to its shareholders at a rate of 15%. This new legislation does not provide for discriminating between high-carbon and low-carbon companies. It would be relevant to reduce this dividend taxation rate for low-carbon companies and increase it for high-carbon ones. Given the lack of taxonomy which could provide the basis for classifying companies as low-carbon or high-carbon, such discrimination could be implemented first in sectors for which there is broad consensus on the activities contributing to the low-carbon transition and the ones that are incompatible with it. These include the energy and transportation sectors. The government could define thresholds for revenue or profits derived from high-carbon and low-carbon activities in these sectors to provide a basis for discriminating between companies eligible or non-eligible to a WHT exemption. Such thresholds could be made more and more ambitious to incentivize firms to strengthen low-carbon activities and reduce high-carbon ones.

These tax benefits are however project- or company-based. They are attached to the low-carbon performance of a project or a company and not to the performance of the financial institution financing them. To incentivize a financial institution to invest more into low-carbon companies and less into high-carbon ones, the income tax weighing on financial institutions could be adjusted based on its low-carbon performance.

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[11] Thomä, Schönauer. 2021. How can financial sector taxes contribute to climate goals? A review of policy options, 2 Degrees Investing Initiative, available at https://2degrees-investing.org/wp-content/uploads/2021/03/Financial-Sector-Taxes-Paper-1.pdf

[12] Machado Meyer, New decree extends tax benefits to green bonds and social bonds, 2020, available at https://www.machadomeyer.com.br/en/recent-publications/publications/capital-markets/new-decree-extends-tax-benefits-to-green-bonds-and-social-bonds?tmpl=articlepdf

[13] Knoch et al. (2022)

In Brazil, the corporate income tax – the *Imposto sobre a Renda de Pessoas Jur ídicas* – stands at a rate of 15%. Income stemming from investments in high-carbon companies could be subject to a higher tax, while income stemming from investments in low-carbon companies could be granted a partial tax exemption. This could be implemented starting with the energy and transportation sectors while awaiting for a more thorough classification of high-carbon and low-carbon activities to be provided by a taxonomy. Defining high-carbon and low-carbon companies in these sectors could be implemented through the same methodology that is proposed to identify companies eligible to a WHT exemption, *ie* through using thresholds for revenue or profits derived from high-carbon and low-carbon activities of companies.

"Income stemming from investments in high-carbon companies could be subject to a higher tax"

4. Directing capital towards key transition sectors

Brazil has a long history of public steering of credit. State interventions in the credit market, to steer it towards priority sectors, along with direct public lending to such sectors were key of the strong development period commonly referred to as the "Brazilian miracle" in the 1960s and 1970s[14]. The State intervention in the credit market has enabled to finance national industrial champions, but also social housing or agriculture programs targeted at the poor. Such interventions are still playing an important role in the financing of the economy.

Today, half of credits in Brazil is still provided by public banks. The main public development bank, *Banco Nacional de Desenvolvimento Econômico e Social* (BNDES), represents 11% of this market. Public banks credit fills the gap of medium-term and long-term finance left open by private banks. In addition, there are many market interventions aimed both at attracting savings to public banks and at offering below market interest rates to organisations financed. For instance, exemption on the 15% interest income tax is used to attract finance which is then lent at preferential terms to priority sectors. Direct State subsidies are also used to finance below market interest rates on lending to such priority sectors. Such directed credit has been on the rise since the global financial crisis in 2008[15].

[14] Bezemer, Ryan Collins, Van Lerven, Zhang. 2018. Credit where it's due: a historical, theoretical and empirical review of credit guidance policies in the 20th century, Institute for innovation and public purpose working paper, available at https://www.ucl.ac.uk/bartlett/public-purpose/sites/public-purpose/files/iipp-wp-2018-11_credit_where_its_due.pdf

[15] Byskov. 2019. Earmarked credit and public banks, in: Spilimbergo and Srinivasan. Brazil – Boom, bust and the road to recovery, International monetary fund, available at https://www.elibrary.imf.org/display/book/9781484339749/ch016.xml

Brazil could use this institutional experience to orient credit towards sectors and companies that are key to the low-carbon transition, such as the energy, transport or agriculture sectors. The BNDES could develop a new credit line aimed at financing low-carbon projects of energy and transport companies. Credit for such projects could be offered at preferential terms through public subsidization or tax exemption. This would send a strong signal to market players and incentivize them to develop low-carbon projects to benefit from preferential loans.

“Brazil could use its experience in credit steering to orient credit towards sectors and companies that are key to the low-carbon transition”

Credit steering in Brazil also takes place through central banks specific policies. Central bank regulations require commercial, private banks to lend for real estate, rural and microfinance projects. Loans to infrastructure projects can also be deducted from central bank’s reserve requirements. Certain credit rates, such as loans directed to the agriculture sector, are also controlled by the central bank[16].

The Brazilian central bank could include green criteria into such tools, or develop new ones. Differential reserve requirements could be introduced for lending to low-carbon and high-carbon projects. This would both incentivize the former and disincentivize the latter and better shield banking institutions from transition risks. The central bank could also impose credit ceilings (floors) for lending to high-carbon (low-carbon) companies or projects.
The logic of credit steering could be extended to market-based finance – especially institutional finance (pension funds, insurers). Collateral requirements of investment funds could be strengthened for the financing of high-carbon projects or companies. Leverage ratios on the financing of such projects or companies could be constrained. A more coercive policy would be to impose a certain ceiling on the holdings of equity of high-carbon companies, which could be progressively reduced, starting with pension funds which are most exposed to long-term transition risks due to their long-term liabilities.

[16] Byskov (2019)

Conclusion

Despite the many initiatives to foster sustainable finance in Brazil, the recent PACTA assessment implemented by RMI shows that capital flows in the country are still strongly misaligned with a less than 2°C global warming. There is therefore a need for Brazilian financial authorities to strengthen both the pace and ambition of sustainable finance policies to ensure the financial sector fulfil its role in the low-carbon transition.

The set of policies laid out in this report could be part of such an agenda. The strengthening of transparency along the green finance value chain and enhanced capacity building of financial actors with regard to sustainable finance matters are indispensable steps. But more ambitious policies are also required, that move beyond enhanced information and knowledge, which is the objective of the two first sets of proposals. Using tax incentives to foster an alignment of capital flows would be an efficient tool to contribute to fixing the failure of the market to orient financial flows where they are due. Credit directing policies, through incentives but also potentially coercive policies such as credit ceilings and floors, constitute the most ambitious policy proposal of this report. They would provide the State with large control over the directionality of financial flows, and therefore the ability to redirect them at the pace and magnitude required to avert climate breakdown.