Climate Finance:

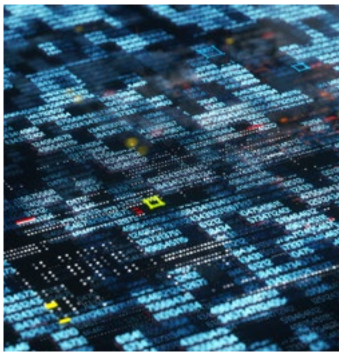
The COP26 Private Finance Hub was set up to help bridge the gap between the Paris Agreement targets and the very significant changes across world economies that are required to meet those targets. It is led by Mark Carney, and its objective for COP26 is to ensure that every professional financial decision takes climate change into account, recognising the central role that private finance has in:

- funding the innovation required to implement climate change, and
- managing climate risks.

The Finance Hub published a report in November 2020 which sets out four principles to do this, recognising the need to drive change through regulation and also to assist the financial sector in identifying the opportunities arising from the transition to net zero to redirect capital. Its intention is to work with the private sector and other stakeholders to develop this four-pronged framework further:

- **Reporting**: to improve the quantity, quality and comparability of climate-related disclosures by developing a common reporting regime implementing the Taskforce for Climate-related Financial Disclosures (TFCD) recommendations.
- **Risk management:** to enable the measurement and management of climate-related financial risks.
- **Returns**: to help investors identify the opportunities arising from the transition to net zero.
- **Mobilisation**: to increase funds available to developing economies to assist them in the transition.

It is estimated that up to USD 100 trillion will be required by 2050 to achieve net zero. Public funds can meet only a relatively small part of that, but private finance can incentivise change and fund the new technologies required. Further, the commitment of developed countries jointly to mobilise USD 100 billion per year by 2020 to address the needs of developing countries expressly recognises that



these funds will come from a wide variety of sources, public and private, bilateral and multilateral.

There are a number of groups that have been set up to facilitate these changes, an example being the Glasgow Financial Alliance for Net Zero (GFANZ), which is made up of 160 banks, asset managers and other financial sector firms responsible for assets of over USD 70 trillion, with those firms being taken from the leading net zero initiatives across the financial system.

Information is key

The TFCD framework has been widely adopted on a voluntary basis, with over 2000 supporters from 55 countries with a market capitalisation of USD12.6 trillion adopting some of the recommendations. However, the TFCD 2020 Status Report found that full alignment with all 11 recommendations is rare, and many companies do not disclose the potential financial impact of climate change on their businesses and strategies. Instead, disclosures are often in sustainability reports, rather than in financial or annual reports. The degree of alignment with the TFCD recommendations on disclosure varies by region, with Europe leading the way, and by sector. The energy sector has the highest percentage of companies which make TFCD-aligned disclosures, followed by materials and building companies.

In order for investors and lenders to have enough information, of a good enough quality, which is comparable across jurisdictions, to allow them to make decisions about the climate change risks and the transition risks facing businesses, the Private Finance Hub has stated its intention to work with countries and international standard-setters such as the IFRS Foundation to make such disclosures mandatory.

Opportunities in funding transition

An objective, standardised reporting framework is also essential for the development of robust green, and sustainable, financial products such as bonds and loans. These are one way in which financial institutions and their investors can capitalise on the enormous possibilities of transition to net zero, and also fund that transition. Green bonds and loans are products where the proceeds must be used for a specific "green" project, or to finance a "green" asset, and issuers or borrowers are expected to report on both the use of proceeds as well as the expected impact. Sustainability-linked loans and bonds, in contrast, contemplate a margin adjustment (or, in the case of bonds, some other variation in financial or structural features) depending on whether various sustainability performance targets, based on sustainability-linked key performance indicators, are met or not. Transition bonds, a relatively new product in the bond markets, may support issuers in hard-to-abate sectors in their sustainability transition.

In order to determine what is "green" or "sustainable" for the purposes of these products, many financial institutions will develop sophisticated eligibility criteria of their own. These are usually very stringent, given the reputational consequences of green-washing or sustainability-washing, but not necessarily consistent and a degree of objectivity and standardisation in determining what is green or sustainable would be helpful. The EU Taxonomy was developed to classify environmentally sustainable economic activities; however, this is not an easy task across all businesses. The EU Taxonomy is highly prescriptive and technical, so has taken time to develop and so far the focus has been on the first two of the six objectives set out in it (climate change adaptation and mitigation) with some politically sensitive activities, such as nuclear power, left out entirely. The UK is intending to produce a taxonomy, which could be more principles-based to avoid becoming mired in stagnant administrative standards, but taxonomies are not necessarily a panacea.

Subsequent reporting on compliance with the green or sustainable elements of the loan or bond is important in ensuring continuing compliance, and mitigating any green- or sustainability-washing. These products have gained a significant amount of traction in Europe, with Asia Pacific and America further behind, mirroring the adoption of the TFCD-recommended disclosures. Companies which already report on environmental sustainability matters have an advantage over smaller companies which may not measure or report on these matters, even if internal reporting requires an external review or audit for the investors or lenders, as is usually the case.

The characteristics of these investments and loans flow into the financial institutions' own reporting requirements, and allow them to manage their portfolio of investments in a way that aligns with their own sustainability commitments.

Risks

The Private Finance Hub has identified risks to businesses arising from physical climate change and from transition to net zero itself, leading to increasing macroeconomic and financial stability risks which will require central bank and supervisory input. The Hub has stated its intention to assess the resilience of companies and the financial sector to these risks, and ensure that the financial sector has the tools to manage them.

Mobilisation and the USD 100 billion commitment

While Europe, in particular, has been focusing on environmental sustainability for some time, and on the green recovery over the last 18 months in particular, the OECD estimates that 70% of the USD 3.5trillion of investment required for the energy transition will need to be in developing countries. Some of this can be met using public funds, but the Private Finance Hub has said that only by also using private finance will it be possible to "turn billions into trillions". The Hub has declared its intention to support the pipeline of bankable projects, and to seek the even closer alignment of the aims of multilateral development banks and development finance institutions with climate change.

These are not easy tasks in the timeframe, and we will look in more detail at how they might impact the financial sector in the next in our series of articles.

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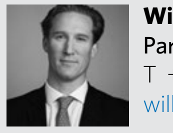

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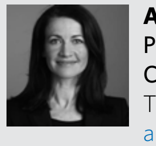

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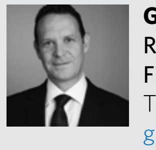

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