Financial services playbook to COP26 and climate finance

October 29, 2021

The 26th session of the United Nations' Climate Change Conference of the Parties (COP26) starts on October 31, 2021 in Glasgow, Scotland.

What you need to know

- UN delegates are convening for a two-week climate change summit, COP26, in the United Kingdom. Their focus will be on financing the global transition to a low-carbon economy;
- The Organisation for Economic Co-operation and Development (OECD) estimated that developed nations delivered USD$79.8 billion in climate finance as of 2019. The finance delivery plan is three years and US$20 billion behind schedule at present.
- According to the International Energy Agency (IEA) and International Monetary Fund (IMF), US$12 trillion to US$20 trillion in global investments is needed for the world to achieve net-zero carbon emissions by 2050; and
- Governments and intergovernmental bodies are calling on financial institutions to support the transition through climate finance.

Climate finance at COP26

COP26 triggers the "ratchet mechanism" for signatories to the Paris Agreement. Member states will release updated nationally determined contributions (NDCs) following COP21.[1] Canada has confirmed its NDCs and has also committed to doubling its International Finance Commitment to $5.3 billion over the next five years. This includes an increase in the proportion of its grants from 30 per cent to 40 per cent.[2]

Among other leadership roles, Canada continues to spearhead the Climate Finance Delivery Plan with Germany. Challenges are expected after the OECD technical paper estimated that the climate finance attributable to developed countries would not hit its 2020 targets of US$100 billion until 2023.[3] As of 2019, just US$79.8 billion had been contributed.[4]

At least 125 countries – including half the OECD's 38 members - have committed to satisfying some form of net-zero emissions by 2050. Based on these commitments and initiatives, the United Nations' Environment Programme announced in advance of COP26, that global temperatures would rise 2.7°C if current national climate pledges were adopted and achieved.[5]

How can this shortfall be met?

The gap in private capital

According to estimates, the economy requires additional global investments in the range of 0.6 per cent - 1.0 per cent of annual global gross domestic product over the next two decades – roughly US$12 trillion to US$20 trillion– for the world to achieve net-zero carbon emissions by 2050.[6] The newly minted Taskforce on Access to Climate Finance has assumed responsibility of transforming and growing public climate finance.[7]

Member states will be discussing methods and tools to encourage private sector investment in sustainable corporate practices. Governments and multilateral development banks have each assumed a substantial role to fill gaps and correct mispricing in the market, but the wallets of financial institutions are key to funding and sustaining a low-carbon economy through **climate finance.**

What is climate finance?

Climate finance refers to the deployment of financial instruments to support activities to reduce greenhouse gas emissions and adapt to the impacts of climate change. Financing a low-carbon transition means:

i. increasing low-carbon investment; and
ii. supporting the transition of carbon-intensive industries.

Climate finance in action

How does climate finance work? Here are some examples of climate finance in action:

- A commercial bank issuing green bonds to help fund certain term or revolving credit facilities with an existing borrower that is shifting operations to mitigate transition risks as a result of internally assessed exposure.
- Purchasing green bonds, prompted by a shareholder resolution or by an ESG-focused management team.
- A corporate borrower issuing corporate debt to fund the purchase of carbon credits in local or foreign markets and other climate related strategies that are permitted under the terms of the existing loan documents.
- A commercial bank reducing its exposure by securitizing loan repayments that are backed by certain assets of the corporation or projected future cash flows.
- A government or development bank providing grants or subsidies that are supported through the issuance of sovereign green bonds or vanilla equivalents.
- A commercial bank offering attractive pricing and financial covenant relief if the client satisfies certain pre-determined activities and/or ratios.

- Another commercial bank that has hired and trained its staff acting as the sustainability structuring agent to review compliance certificates that contain adequate disclosure from the corporate borrower.

How can financial institutions assess climate finance opportunities?

The need for private capital for climate financing is clear. As is the necessity of a market that facilitates efficient and informed investment decisions. As outlined in a recent BLG article on the Task force on climate-related financial disclosures (TCFD) implementation, financial institutions need access to accurate, dynamic and standardized information. These details enable commercial banks to allocate capital to organizations that will create more productive, long-term focused outputs.

A credible transition plan that can be monitored and reassessed is a pre-requisite to a burgeoning private sector transition. An understanding of how certain types of risks interrelate with a company's key performance indicators will be integral to success. With reliable information, financial institutions can create financial plans that identify leaders and stragglers, enabling them to leverage existing relationships rather than divesting to reshape their portfolios.

In the absence of mandatory reporting - at minimum, financial institutions should inquire about the following details when considering a climate finance opportunity:[8]

1. Whether a company has a net-zero target that covers scopes 1, 2 and 3 emissions, along with short and medium-term milestones to monitor progress;
2. The sophistication of the company's plan, including the appropriate balance of emissions reductions and offsets for its sector, dynamic internal carbon pricing, and COP26-aligned investment and capital expenditure;
3. The governance structure of the plan, including whether the board has effective oversight and how success is linked to executive remuneration; and
4. Whether its climate reporting and risk assessment is consistent with TCFD recommendations.

What are the next steps for private finance?

Overall, financial institutions should require internal frameworks to:

a. assess the credibility of their existing portfolio companies' transition plans, as well as, the plans of new clients, and
b. measure alignment of their portfolios simultaneously with the transition of markets to a low-carbon economy.

As a starting point, commercial banks should review their existing portfolios and begin discussions with clients. BLG's Environmental, Social and Governance and Climate Change groups have the resources to assist with these discussions.

As the market and technologies for climate finance matures, the pipeline of bankable finance opportunities will continue to grow. Open-source resources are available to organizations that are thinking about ways to improve their competitiveness through the transition.[9] Think tanks continue to refine playbooks for financial institutions and companies that operate in various sectors, so that management teams can inexpensively develop internal policies and protocols.

If thoughtfully considered and properly adopted, private investors and their recipients can not only mitigate the effects of climate change but can do so while enhancing their competitive edge.

BLG at COP26

The demand for private finance is apparent and pervasive. Ideas will be in high supply at COP26. Whether financial institutions react as the delegates hope remains to be seen. BLG is attending COP26 and we will continue to update the financial services sector on important developments. See our follow up article on COP26 and the future of financial services.

To learn more about how these updates may affect or have opportunities for your organization, please contact any of the authors or key contacts below.

[1] Article 4(4) of the Paris Agreement.

[2] UN Climate Change Conference UK 2021, COP26 Presidency Compilation of 2021 - 2025 Climate Finance Commitments (October 2021).

[3] International Monetary Fund, Global Financial Stability Report – Covid 19, Crypto, and Climate: Navigating Challenging Transitions (October 2021).

[4] Organisation for Economic Co-operation and Development, Forward-looking Scenarios of Climate Finance Provided and Mobilised by Developed Countries in 2021 - 2025 (October 2021).

[5] United Nations, Environment Programme, press release on October 26, 2021.

[6] *Supra* note 3.

[7] UN Climate Change Conference UK 2021, Taskforce on Access to Climate Finance: Revised Concept Note.

[8] Mark Carney, UN Special Envoy for Climate Action and Finance and the Prime Minister's Finance Adviser for COP26, Building a Private Finance System For Net Zero (October 2021).

[9] A few examples include: reports by Science Based Targets initiative, sector-specific resources developed by the Mission Possible Partnership, the 1.5°C Business Playbook by the Exponential Roadmap initiative, the Lender's Handbook on Green Home Retrofit and Technologies, Best Practices Guide to Sustainability Linked Leveraged Loans by the Loan Market Association, Measuring Portfolio Alignment by the Portfolio Alignment Team, and the Climate Transition Finance Handbook by the International Capital Markets Association.

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Expertise

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