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Insights

THE ROAD TO COP26—EXPLORING THE ROLE OF PRIVATE FINANCE

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SUMMARY

Environment analysis: As part of our series of environmental analyses preceding the 26th UN Climate Change Conference (COP26), this news analysis focuses on the role of private finance in achieving the emission reduction goals of the Paris Agreement. It discusses the four main objectives of private finance work identified in the pre-COP26 strategy report, Building A Private Finance System for Net Zero, and how they are set to be delivered.

Introduction

COP26 is due to take place in Glasgow from 31 October to 12 November 2021 after being delayed a year due to coronavirus (COVID-19). The historic 2015 Paris Agreement provided a framework for tackling climate change, however considerable questions remain unresolved including:

- the balance between mitigation and adaption
- the extent to which the approach to climate change should address global inequalities
- the role of the private sector, and
- the role of private finance

Of these issues, private finance work looks set to be particularly important following the establishment of the COP26 Finance Hub, led by Mark Carney, and the publication of a strategy report titled 'Building A Private Finance System for Net Zero' (the Report) in November 2020.

At COP26, countries will be expected to reaffirm their commitments to securing global net zero by 2050 and 'keeping 1.5 degrees within reach'. Countries will be encouraged to protect and restore ecosystems and build defences, warning systems and resilient infrastructure and agriculture to protect the environment and the Paris Rulebook may be finalised, encouraging collaboration between governments, business and civil society. Developed countries will also be asked to deliver on their promise to mobilise at least $US 100bn in climate finance per year by 2020.

For more information, see News Analysis: Road to COP26—what is it and why is it important?

Objectives

The Report sets out four key objectives and the actions needed to deliver them. These are:

- reporting
- risk management
- returns, and
- mobilisation

Reporting

The Taskforce for Climate-related Financial Disclosures (TCFD) was established in December 2015. It set out a series of recommendations in its 2017 report designed to provide a framework for organisations to 'develop more effective climate-related financial disclosures through their existing reporting process'. It recommended that climate-related financial disclosures are included in companies' annual financial filings, to improve the transparency and quality of disclosures and encourage more sustainable practices. For more information on the 2017 report, see: TCFD recommendations for climate-related financial disclosures—LNB News 29/06/2017 110.

The TCFD has already made a significant impact. In March 2021, the TCFD reported that it had more than 2,000 supporters, with a market capitalisation of over $US 19.8trn, including over 859 financial firms, responsible for assets of $US 175trn.

The Report contends that the quality and quantity of climate-related financial disclosures should be improved, though, and that the private finance sector must voluntarily disclose in line with the full set of TCFD recommendations. It recommends that reporting is made mandatory through the introduction of new national and international legislation and that coalitions of countries are established to enforce such reporting requirements.

The Report also recommends other measures, such as financial regulators and central banks issuing guidance to financial firms on climate-related reporting and stock exchanges developing TCFD-compliant listing guidance.

Risk management

The second objective identified is that physical and transition risks of climate change are managed effectively. While the physical risks that arise from the increased frequency and severity of climate and weather-related events are well documented, there are also significant transition risks arising from changes in climate policy, technology and market sentiment in the move to a net-zero economy.

The COP26 Private Finance Hub has recommended that central banks and/or supervisors commit to measures including stress tests on banks and insurers against climate scenarios, integrating climate risk considerations into portfolio management and themselves disclosing in line with the TCFD recommendations. The Report also sets out specific recommendations for the International Monetary Fund (IMF) and the Financial Stability Board (FSB), as well as for other international prudential standard setters and finance ministries to better assess the resilience of companies and financial sector to climate risks.

It is hoped that COP26 will build on the steps already taken by bodies such as the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) in recent years. The NGFS is a group of Central Banks and Supervisors who are willing, on a voluntary basis, to share best practices and contribute to the development of climate risk management in the financial sector. The NGFS represent around 75% of global greenhouse gas emissions and are responsible for the supervision of all of the global systemically important banks and two thirds of global systemically important insurers.

Returns

The third objective identified in the Report is that, as countries turn the Paris Agreement goals into nationally legislated objectives, companies and financial firms will need to adapt their business models and reallocate capital accordingly.

While this could present significant commercial opportunities for some, the report recommends that frameworks are introduced to enable investors to make informed decisions on whether companies and portfolios are transition-ready. The COP26 Private Finance Hub believes that this can be done in co-ordination with academic and NGO communities and recommends that the private sector is encouraged to review approaches to measuring portfolio alignment; expose further work needed; and discuss next steps for developing a reliable metric.

Once net zero commitments from countries and companies have been secured, credible transition plans will need to be put in place. The development of transition plans are already being supported by the Race to Zero campaign, the Science Based Targets initiative (SBTi), the Mission Possible platform and the Exponential Roadmap's 1.5C Business Playbook. The report recommends that financial institutions continue to work with these initiatives, as well as others such as the Net Zero Owner Alliance and the Climate Action 100+, in order to publish credible transition plans.

Mobilisation

The last objective relates to increasing private financial flows to emerging and developing economies, by connecting available capital with investable projects and encouraging new market structures. The report suggests assisting the Climate Finance Leadership Initiative (CFLI) achieve the next steps set out in its report 'Financing the Low Carbon Future'. Such steps would include building from existing initiatives that look to address barriers to financing sustainable infrastructure, such as the work of the G20 and Global Infrastructure Hub, the work of the OECD, and Fast Infra.

Risk management tools can be developed to 'de-risk investment' and the activity of multilateral development banks, new development banks, and development finance institutions can be aligned with the Paris Goals, as 'these institutions have a unique ability to enable countries to create private markets for low-carbon and resilient investment'. COP26 also looks set to encourage the development of the infrastructure for scaling up high-quality voluntary carbon markets. In Carney's view, 'a scalable, high-quality, transparent and credible market structure could turn the current $US 300m spent on these projects through the voluntary market into tens of billions of dollars every year'.

Conclusion

There are a wide range of issues that could be addressed at COP26 and the parties will not be able to tackle them all. The role of private finance work will be a key focus point and progress in this area has the potential to rapidly accelerate the global response to climate change. In the words of the COP26 Finance Hub, 'every company, bank, insurer and investor will have to adjust their business models, develop credible plans for the transition and implement them'.

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