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The impact of COP26 announcements on financial institutions

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Introduction

At the UN COP26 summit held in Glasgow, Rishi Sunak announced plans for the UK to become a net zero financial centre. In this article, we summarise the key pledges and take-aways from COP26, including the impact on financial institutions.

It addresses:

- what the countries participating in COP26 formally agreed;
- pledges made by countries during COP26 (which fall outside of the Glasgow Climate Pact); and
- the impact COP26 announcements will have on financial institutions.

What did the countries participating in COP26 agree?

The UK government's ambition as host of COP26 was to build on the goal set by the Paris Agreement – to limit the global average temperature increase to well below 2°C, preferably to 1.5°C, in comparison to pre-industrial levels.

At the conclusion of the COP26 summit, participating countries signed the Glasgow Climate Pact. The key elements of this pact are summarised in the table on the following page.

Key elements of the Glasgow Climate Pact	
Article I: Science and urgency	• Recognises the importance of the best available science for effective climate action and policymaking. • The Article also stresses the urgency of enhancing ambition and action in relation to mitigation adaptation and finance this decade.
Article II: Adaptation	• Notes with serious concern findings from a working group to the Intergovernmental Panel on Climate Change Sixth Assessment Report, including that climate and weather extremes and their adverse impacts on people and nature will continue to increase as temperatures rise. • Emphasises the urgency of scaling up action and support, including finance, to enhance adaptive capacity, strengthen resilience and reduce vulnerability to climate change.
Article III: Adaptation finance	• Notes with serious concern that the current provision of climate finance for adaptation is insufficient to respond to climate change impacts in developing countries. • As part of a global effort, the pact urges developed countries to scale up the provision of finance to respond to the needs of developing countries. • Calls upon multilateral development banks, other financial institutions and the private sector to enhance finance mobilisation to deliver the scale of resources needed to achieve climate plans, particularly for adaptation. • Encourages participating countries to continue to explore innovative approaches and instruments to mobilise finance for adaptation from private sources.
Article IV: Mitigation	• Reaffirms the goal to hold the increase in the global average temperature to well below 2°C compared to pre-industrial levels and pursue efforts to limit this increase to 1.5°C compared to pre-industrial levels. • Recognises that limiting global warming to 1.5°C compared to pre-industrial levels requires rapid reductions in global greenhouse gas emissions, including reducing carbon dioxide emissions by 45 per cent by 2030 relative to the 2010 level, and to net-zero by 2050. • Calls upon parties to rapidly scale up deployment of clean power generation and ***phasedown*** unabated coal power and inefficient fossil fuel subsidies. Originally the pact had the phrase ***phaseout***. However, India and China made a last-minute intervention to change this to ***phasedown***.

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Key elements of the Glasgow Climate Pact cont'd	
Article V: Finance, technology transfer and capacity-building for mitigation and adaptation	• Urges developed countries to provide enhanced support, including through (amongst other things) financial resources to assist developing countries with mitigation and adaptation in continuing their obligations under the United Nations Framework Convention on Climate Change (the **Convention**). • Emphasises the need to mobilise climate finance ***from all sources*** to reach the level needed to achieve the goals of the Paris Climate Agreement, including support for developing countries beyond USD 100 billion per year. • Notes with deep regret that the goal of developed countries to mobilise USD 100 billion per year by 2020 has not been met and welcomes increased pledges made by certain countries at COP26. • Urges developed countries to urgently deliver on the USD 100 billion goal through to 2025.
Article VI: Loss and damage	• Acknowledges climate change has already caused and will increasingly cause loss and damage that, as temperatures rise, impacts from climate and weather extremes, will pose an ever-greater social, economic and environmental threat. • Reiterates urgency of scaling up action and support, including (amongst other things) finance for implementing approaches to averting, minimising and addressing loss and damage associated with the adverse effects of climate change in developing countries that are particularly vulnerable to those effects. • Urges developed countries, operating entities of the Financial Mechanism (this mechanism was established by the UN to facilitate the provision of financial resources to developing country parties from developed countries), United Nations entities, and intergovernmental organisations and other bilateral and multilateral institutions, including NGOs and private sources, to provide enhanced and additional support for activities addressing loss and damage associated with the adverse effects of climate change.
Article VII: Implementation	• Strongly urges parties that have not yet met their outstanding pledges under the Convention to do so as soon as possible. • Recognises the need to ensure just transitions that promote (i) sustainable development and eradication of poverty, (ii) the creation of decent work and quality jobs, including through making financial flows consistent with a pathway towards low greenhouse gas emission and climate-resilient development, including through deployment and transfer technology, and (iii) the provision of support to developing countries.
Article VIII: Collaboration	• Recognises the importance of international collaboration on innovative climate action, including technological advancement, across all actors of society, sectors and regions, in contributing to progress toward the objective of the Convention and the Paris Agreement.

The participating COP26 countries also agreed on certain pending items that prevented the full implementation of the Paris Agreement. Namely, Article 6 of the Paris Agreement relating to carbon markets. The idea is that countries with higher emissions can buy credits representing emissions reductions from nations that lower pollution more than they have pledged. There is also a possibility for private companies to invest in projects that cut emissions in developing countries which would generate credits that could also be traded. In the wake of the Paris Agreement, there were concerns that emissions reductions could be claimed by multiple companies or countries. However, the rules agreed in Glasgow contain provisions to avoid this. There are already voluntary carbon markets in existence, but it is hoped that the agreement reached in Glasgow will bring greater transparency to those markets.

What is the impact of COP26 on financial institutions specifically?

Net zero financial centres	• At the COP26 summit, Rishi Sunak announced plans for the UK to become a net zero financial centre. • As part of this, the Chancellor announced that from 2023, firms will need to publish transition plans aligning with the government's net zero commitment or explain why they have not done so. See more on UK developments here. • In due course, it is likely that other countries will follow suit (with obvious ramifications for firms operating in those countries if that happens).
Deploying finance to meet climate targets	• The Glasgow Climate Pact and the other pledges made at COP26 envisage that the private sector will have a significant role to play in deploying finance to reach the various ambitions that have been set. • For example, in the Glasgow Climate Pact, Article III calls upon multilateral development banks, other financial institutions and the private sector to enhance finance mobilisation to deliver the scale of resources needed to achieve climate plans, particularly for adaptation. Also, Article V emphasises the need to mobilise climate finance from all sources to reach the level needed to achieve the goals of the Paris Climate Agreement, including support for developing countries beyond USD 100 billion per year.
Just transition	• As noted above, regarding implementation of the Glasgow Climate Pact, Article VII recognises the need to ensure **just transitions** that promote sustainable development and eradication of poverty, and the creation of decent work and quality jobs at the same time as finding a pathway towards low greenhouse gas emissions and climate-resilient development. • Financial institutions in the UK are already considering their role in a just transition. In November 2020, more than 40 banks, investors and other financial institutions joined forces with trade unions and universities to launch "Financing a Just Transition Alliance", and in 2021 the alliance published a report of the UK Financing a Just Transition Alliance. This alliance set out five strategic recommendations: - **Strategy and leadership**: embed the just transition into climate strategies and financing plans, supported by the Board, and signal the importance of the just transition internally and externally. - **Engagement**: integrating just transition into engagement on corporate net-zero plans between investors and the companies they hold, and between banks and clients they lend to. - **Capital allocation**: actively seek to finance companies committed to positive social impact for workers, communities and consumers on the road to net zero. Make it clear to potential investees and clients that these factors will be included in the firm's appraisal and due diligence policies for investment and lending. - **Policy dialogue**: encourage policymakers to put in place the policy frameworks that can scale up financing for the just transition, covering real economy frameworks as well as public finance and financial policies. - **Delivering impact and measuring contribution**: include just transition factors in the way that financial institutions deliver positive social and environmental impacts at both the asset and system level and report these contributions to their clients and stakeholders in public disclosures.
Impact of the pledges that countries have made	• The pledges that countries have made will impact domestic legislation. • For example, in connection to deforestation pledges, the EU has proposed legislation to prevent the import of commodities linked to deforestation. Financial institutions operating in the EU will need to consider this in their due diligence as it may prevent them from financing or investing in certain commodities in the future.

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Institutions are making their own climate-related commitments	**GFANZ** • As noted above, financial institutions that are GFANZ members have made various commitments, including using science-based guidelines to reach net-zero emissions across all emissions scopes by 2050 and set 2030 interim targets, amongst other things. **Deforestation commitment** • Over 30 financial institutions representing USD 8.7 trillion in assets announced their endorsement of a commitment letter on eliminating commodity-driven deforestation. These firms have embraced the COP Presidency's call for financial institutions to commit to achieving zero deforestation impacts across investment and lending portfolios by 2025 and call on other financial institutions to do the same. • By the end of 2022, these firms have committed to: - assess the exposure to deforestation risk through financing or investment in clients / holdings, with a focus on "forest-risk" commodities (for example, palm oil, beef, soy etc); - establish investment / lending policies addressing exposure to agricultural commodity-driven deforestation; - deepen or begin engagement of highest risk clients / holdings on deforestation in their supply chains, operations and / or financing; and - engage on policy to support an enabling environment for businesses to avoid deforestation risks and impacts. • By 2023, these firms will disclose deforestation risk and mitigation activities in portfolios, including due diligence and engagement. • By 2025, these firms will publicly report their progress, in alignment with peers, on the milestones to eliminate forest-risk agricultural commodity-driven deforestation in the underlying holdings of their investment / lending portfolios through company engagement, and only provide finance to clients that have met risk-reduction criteria. Naturally, the commitments made by large financial institutions will have a knock-on effect. For example, by their engagement with portfolio companies and their client base. Firms that have not made these commitments may also face pressure from their stakeholders to do so.
Sustainability disclosure standards	• The International Financial Reporting Standards Foundation's (**IFRS**) Trustees announced at COP26 the creation of a new standard-setting board, the International Sustainability Standards Board (**ISSB**). • The intention is for the ISSB to deliver a global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions. Jurisdictions can adopt the standards on a voluntary basis. • The IFRS Foundation released a draft climate-related disclosures prototype that includes recommendations from the Technical Readiness Working Group and builds on the work of other entities involved in establishing disclosure standards, including the Task Force on Climate Related Financial Disclosures (**TCFD**). This prototype is subject to further consultation but does provide some insight into the new standards that will impact financial institutions, and so it is worth firms considering this. The disclosures namely relate to climate-related risks that an entity is exposed to and climate-related opportunities available to and considered by the entity. • The UK made a series of announcements during COP26, including "Greening Finance: A Roadmap to Sustainable Investing". This included details on the government's plans to develop a new sustainability disclosures regime (**SRD**) and a green taxonomy. The UK government promises to make new standards developed by the ISSB a key component of the SRD. See more on UK developments here.

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Impact of commitments made by Central Banks	**The Glasgow Declaration** • During COP26 the Glasgow Declaration was published by the Network of Central Banks and Supervisors for Greening the Financial System (**NGFS**). This reiterated the NGFS's willingness to contribute to the global response required to meet the Paris Agreement objectives and green the financial system. • The Glasgow Declaration notes that in light of the urgency of climate change, the NGFS will expand and strengthen collective efforts to improve the resilience of the financial system to climate-related and environmental risks and will encourage the scaling up of financing flows needed to support a transition towards a sustainable economy. • In the coming years, the NGFS will (amongst other things): - further enhance and enrich its climate scenarios, providing on a regular basis an important public good for a broad range of stakeholders (both public and private); - deepen its analysis on integrating climate change considerations into monetary policy strategies and frameworks; and - facilitate uplift in supervisory capabilities and global consistency of supervisory practices. • Private financial institutions are likely to be impacted by the Glasgow Declaration as Central Banks seek to meet their commitments through supervision, monetary policies and standard setting. **The Basel Committee on Banking Supervision** • Following COP26, the Basel Committee on Banking Supervision (**Basel Committee**) issued a public consultation on principles for the effective management and supervision of climate-related financial risks. • The Basel Committee is examining the extent to which climate-related financial risks can be addressed within the Basel Framework by identifying potential gaps in the current framework and considering measures to address those gaps. • Regarding supervision, a review of the existing Basel Framework concluded that the core principles for effective banking supervision (**BCPs**) and the supervisory review process (**SRP**) are sufficiently broad and flexible to accommodate additional supervisory responses to climate-related financial risks. However, supervisors and banks could benefit from the Basel Committee's guidance to foster alignment of expectations for addressing those risks. • Through the consultation document, the Basel Committee seeks to promote a principles-based approach to improving risk management and supervisory practices relating to climate-related financial risks. This builds on the review of the current Basel Framework, in particular, the BCPs and SRP. The consultation includes 18 high-level principles. • Principles 1 to 12are relevant for banks and provide guidance on effective management of climate-related financial risks. These principles include, amongst others, that: - banks should develop and implement sound practices for understanding and assessing the impact of climate-related risk drivers on their business and the environment they operate within; - board and senior management should clearly assign climate-related responsibilities to members and committees and exercise effective oversight of climate-related financial risk; and - where appropriate, banks should use scenario analysis, including stress testing, to assess the resilience of their business models and strategies to a range of plausible climate-related pathways and determine the impact of climate-related risk drivers on their overall risk profile.

What other commitments were made at COP26?

As COP26 progressed, a number of pledges and side agreements were made that fell outside of the Convention itself. Some of the key pledges which are relevant to financial institutions are noted below:

Global Methane Pledge	• 110 countries representing nearly 50 per cent of global anthropogenic methane emissions and over two-thirds of global GDP have pledged to take voluntary actions to contribute to a collective effort to reduce global methane emissions at least 30 per cent from 2020 levels by 2030. • The pledge recognises the essential roles that the private sector, including financial institutions, play to support its implementation and welcomes their efforts and engagement.
Glasgow Leaders' Declaration on Forests and Land Use	• 141 countries committed to working collectively to halt and reverse forest loss and land degradation by 2030. Together, the countries account for 90.94 per cent of the world's forests. • The declaration includes strengthening shared efforts to (amongst other things): - conserve forests and other terrestrial ecosystems and accelerate their restoration; - reaffirm international financial commitments and significantly increase finance and investment from a wide variety of public and private sources; and - facilitate the alignment of financial flows with international goals to reverse forest loss and degradation, while ensuring robust policies and systems are in place to accelerate the transition to an economy that is resilient and advances forest, sustainable land use, biodiversity and climate goals. • The pledge has faced criticism for having no enforcement mechanism. However, the EU has since announced regulations that would ban certain products linked to deforestation from entering the EU, and we await developments from the other pledging countries.
Global Forest Finance Pledge	• Norway, Japan, South Korea, Canada, the USA, the UK, and the European Commission on behalf of the EU (as well as Germany, France, Belgium, the Netherlands and Denmark), pledged to collectively provide USD 12 billion for forest-related climate finance between 2021 and 2025. • The pledge will provide support for climate mitigation and adaptation, help address the systemic drivers of forest loss and enable the conservation, sustainable management, and restoration of forests in certain countries. These will be delivered through funding for results-based payments, technical and financial cooperation for capacity building, as well as other activities (including activities that support and strengthen deforestation-free and sustainable financial markets and leveraging significant private investment in sustainable forest management, forest protection and sustainable deforestation-free agriculture).
Glasgow Financial Alliance for Net Zero (GFANZ)	• Over 450 financial firms across 45 counties with assets totalling more than $130 trillion have become GFANZ members. • Led by Mark Carney, GFANZ members have committed to manage their assets in line with achieving net zero targets. • GFANZ members must: - align with the UN's Race to Zero criteria; - use science-based guidelines to reach net-zero emissions across all emissions scopes by 2050; - set 2030 interim targets that represent a fair share of 50% decarbonisation required by the end of the decade; - set and publish a net-zero transition strategy; - commit to transparent reporting and accounting on progress against their targets; and - adhere to strict restrictions on the use of carbon offsets

Conclusion and practical considerations for firms

As part of our sustainable finance series, we have sought to summarise the updates at the EU level (read here) and the UK level (read here), as well as providing a global update in this article.

With various agreements, commitments, rules and standards being published in rapid succession at both the domestic and international levels, it can be quite difficult to unpick all the moving parts relating to climate change. What is clear is that financial institutions are under increasing pressure from stakeholders (including governments, regulators, clients and their own employees) to act in ways that are sustainable and in keeping with climate change mitigation objectives.

However, with this pressure comes a risk of firms wanting ***to be seen to be doing good*** but possibly without the internal frameworks in place to ensure they are ***actually doing good***. Therefore, it is therefore important that firms (if they have not done so already) start to consider their internal frameworks and improve their governance arrangements in this area.

Practical considerations for firms include:

- making a senior manager responsible for firms' green initiatives (something which UK banks must do by the end of 2021) and consider linking those initiatives to a just transition;
- robustly scrutinising their disclosures around sustainability to ensure they are not "greenwashing" and what they do in practice is consistent with their disclosures;
- robustly scrutinising ESG data from third parties;
- enhancing investment due diligence to ensure ESG factors are properly considered;
- mapping the risks posed by climate change on the firm, and where relevant, its investee companies and its products;
- conducting stress tests relating to the impact climate change may have on the firm and its products and services;
- tracking regulatory and legislative updates and guidance from supervisory authorities relating to climate change commitments at both the national and international level;
- working with industry and trade groups to help shape policies as they develop; and
- working with advisers to understand the impact that new regulations, legislation, principles and guidance may have on the firm and its product offering.

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