OliverWyman

REFLECTIONS FROM COP26 FOR THE FINANCIAL SECTOR

November 2021

As representatives from across the financial services sector return home from the United Nations Climate Change Conference in Glasgow, there is a lot for the industry to be proud of. Finance Day on November 3 at COP26 put the industry at the centre of a COP agenda for the first time. The message from the stage at the conference was clear: the money is there, the ambition is there, and the plumbing is being built at pace.

Away from the stage, there was a real sense of optimism around the building momentum across the sector and the positive contribution that financial institutions can make. However, there was also a sense of realism about the scale of the challenge ahead. The required dramatic commitment will naturally draw attention from a multitude of stakeholders, each of whom will expect transparency, credibility, and demonstrable progress.

This short note summarises the key developments and their implications for Financial Institutions, including:

- **The financial sector has mobilised at scale.** Now the remaining 60% of the financial services industry needs to consider following suit
- **Financial plumbing is being reworked** including announcement of a new International Sustainability Standards Board, and the UK announcing its intent to make net zero transition plans mandatory.
- **Fossil fuel financing remains the thorniest issue,** with NGOs and activists remaining at odds with financial institutions on the way forward.
- **Capital requirements for climate risk are on the horizon,** with one hundred central banks signing a declaration including a commitment to advance supervisory practices.
- **More needs to be done to mobilise capital in the most impactful areas**, especially to help emerging markets and developing countries reach net zero.
- **Nature and Biodiversity are the next big focus** with over 100 nations pledging to end deforestation and land degradation by 2030, and 33 financial institutions committing to halt financing of agricultural commodity-driven deforestation by 2025.

Each of these developments is explored in greater detail below.

THE FINANCIAL SECTOR HAS MOBILISED AT SCALE

The **Glasgow Financial Alliance for Net Zero (GFANZ)** announced that more than 450 firms in the financial services sector across 45 countries that represent more than $130 trillion of financial assets have committed to **align their activities to transitioning to net zero** and to work to deliver the $100 trillion investment needed to achieve net zero over the next three decades.

Numbers of this magnitude can be difficult to grasp. But the scale and significance of the announcement should not be underestimated. Firms representing 40% of the financial system have committed to set concrete, science-based, net zero-aligned interim targets for portfolio emissions, back them up with credible transition plans and actions, and report progress regularly. In so doing, they have created a new lens through which to look at their businesses and issued a challenge to the remaining 60% of the financial services industry to follow suit.

Delivering these targets will require real change. Many institutions **have published interim targets** in the run up to and during COP26. For example, a growing number of banks have now set targets for the power sector, and these are on average targeting 40-60% reductions in portfolio emissions by 2030. Along this journey, financial institutions will need to strengthen their external disclosures and stakeholder communications and provide transparency on their scope and assumptions. It is important that they are beyond reproach on "greenwashing".

The financial services industry will not achieve net zero emissions unless the real economy also reaches net zero. Financial firms must engage with clients and investees on their transition strategies and innovate new financing solutions to support their efforts to decarbonise. But bold policy change and government action will also be required to move at the pace required to hit net zero by 2050. This was the focus of the **GFANZ Policy Call to Action,**[1] which urges governments to: set economy-wide and sector level targets aligned to 1.5°C, reform financial sector supervision to support net zero transitions, price carbon emissions, phase-out of fossil-fuel subsidies, and make net zero transition plans mandatory.

GFANZ also announced that it will carry this work forward beyond COP26 with Michael Bloomberg joining Mark Carney as co-chairs. Mary Shapiro and Nigel Topping will be co-Vice Chairs. A new permanent secretariat will be put in place. This group will continue the mission to provide industry-wide coordination on turning commitments into action.

THE FINANCIAL PLUMBING IS BEING RE-WORKED AT PACE

The **IFRS Foundation** announced the formation of a **new International Sustainability Standards Board (ISSB),**[2] which seeks to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs — building further upon the work of the Task Force for Climate-Related Financial Disclosures (TCFD), which will continue to be taken forwards in 2022.

This is a major step toward improving the quality of data on net zero that is so vital to enable informed financial decision making. It means that companies will be able to report on climate issues affecting them under a single global standard. **IOSCO will assess the ISSB output,** and if positive, recommend adoption by the 130 domestic regulators it represents.

1 GFANZ "Policy Call to Action" report is available here.

2 Details on the International Sustainability Standards Board (ISSB) are available here.

This will accelerate and standardise the introduction of mandatory external climate disclosures. Importantly, it will also likely lead to a more prescriptive approach.

The UK announced the intention to become the world's first net zero aligned financial centre, with a new requirement for mandatory **net zero transition plans** for UK financial institutions and companies. A new task force will be established in the UK government to develop standards before the end of 2022 with the expectation that firms will be required to publish transition plans in 2023, and that this will cover both public and private firms. Additionally, the UN Secretary General announced an **expert committee to develop standards for corporate net zero targets** to enhance transparency and comparability of commitments.

The recently created the Net Zero Financial Services Providers Alliance, also part of GFANZ, brings together a group including exchanges, index providers, rating agencies and auditors, recognising the role that these firms play in providing the infrastructure, products, and services to support economy-wide net zero transition.

FOSSIL FUEL FINANCING REMAINS THE THORNIEST ISSUE

Fossil fuels were an ever-present topic throughout the week. NGOs and activists were often at odds with financial institutions with regard to how the world should be weaned off its dependency. Coal, one of the "three Cs" highlighted by the hosts coming into the conference, has seen the most progress. More than 23 countries **made new commitments to phase out coal,** a significant development that growing numbers of financial institutions are reflecting in their own lending and investment policies. The global methane pledge, endorsed by 100 countries representing 70% of the world's GDP, also offers a practical step for financial institutions to get behind. There has also been some progress on acting to reduce demand for fossil fuels, in particular through the Glasgow Declaration on Zero-Emission Cars and Vans, which aims to end the sale of internal combustion engines by 2035 in leading markets and by 2040 worldwide.[3]

The debate more broadly, however, remains polarized. Some observers have cited the **IEA's Net Zero by 2050 Scenario** as proof that fossil fuel financing needs to be halted immediately for 1.5°C commitments to be met. In actual fact, the IEA's Net Zero by 2050 Scenario implies an immediate halt on exploration, but allows continued investment in existing sources of oil and gas production. Other credible agencies and institutions (e.g. NGFS, OECM, IPCC) also have net zero pathways, in which fossil fuel exploration is reduced rather than halted. These scenarios are plausible paths, not definitive roadmaps. So at one level this debate highlights the need for the industry to use and talk about them in a way that builds common understanding across stakeholders, without diluting ambition.

3 Details on fossil-fuel powered transport announcements are available here.

More fundamentally, many leaders in the financial sector feel strongly that the right path forward is a carefully managed transition that focuses on constraining both supply and demand in parallel. They point to recent energy price spikes and governments' swift actions to address them as evidence of the risk that abrupt action could lead to a loss in popular and political support for the transition. There is also growing concern amongst leaders in the financial industry that as mainstream finance moves to net zero, fossil fuel companies may turn to shadow banks and private capital for finance. Such actors are likely to maximize the commercial potential of fossil fuel assets. Indeed, there is already growing anecdotal evidence that these transactions are happening today. **Responsible retirement** of fossil fuel assets will be a key theme over the coming years, requiring the private and public sectors to come together to develop solutions.

As more banks set targets for the oil and gas sector over the coming months, this issue is likely to remain centre stage. The onus will be on those financial institutions to make the case for engagement with the sector to show progress and to demonstrate that they are having an impact.

CAPITAL REQUIREMENTS FOR CLIMATE RISK ARE ON THE HORIZON

The Network for Greening the Financial System (NGFS) announced that 100 central banks have now joined their network and signed the **NGFS Glasgow Declaration,**[4] which included a continued commitment to advance supervisory practices. Additionally, the Bank of England announced that it will shift gears to **actively supervise firms on climate-related financial risks**[5] and recognises that **capital may have a bigger role to play** in providing resilience against the consequences of climate change.[6] Work is already underway domestically and internationally on how to integrate climate into the capital frameworks of banks and insurers, but the timing and specificity regarding how best to capitalise under Pillar 1 and Pillar 2 is still to be determined.

The core processes required to align internal incentives with net zero targets already exist in nearly all financial institutions. These processes need to be enhanced to ensure that climate considerations are reflected in risk management, scenario analysis, strategic planning, capital allocation and credit/investment decisions. The coverage and quality of data is currently low and industry standards are still evolving, but firms cannot use these challenges as an excuse for not making progress.

4 The NGFS Glasgow Declaration is available here.

5 PRA's 2021 Climate Change Adaptation report is available here.

6 "Laying the Foundations for a Net Zero Financial System" — speech by Andrew Bailey, Bank of England is available here.

While supervisors continue to focus on climate risk and resilience, increasing attention is being paid to net zero target setting, transition plans, and the integrity of those plans and progress. It is notable in this light that GFANZ will periodically report on its work to the **Financial Stability Board (FSB)**.

Since its first call to action in 2019, the NGFS has been encouraging its members to integrate sustainability into their own portfolio management. Over the past week, the Bank of England joined the ECB in integrating climate considerations into their **bond purchasing arrangements** to reduce its financed emissions by 25% by 2025.[7] The Bank of England's approach will both exclude companies failing to meet disclosure and reduction requirements, while shifting allocations towards better performing companies from a climate perspective.

MORE NEEDS TO BE DONE TO MOBILISE CAPITAL IN TARGET AREAS

A central focus of the broader COP26 discussions is the need to scale financial flows to emerging markets and developing countries (EM&DCs) to help them reach net zero, with annual investment needs for clean energy alone expected to be greater than $1 trillion by the end of the decade, a sevenfold increase from today's levels.[8] An enhancement of the **"country platform approach"** has been called for to scale private capital flows to EM&DCs, bringing together the resources of the official sector, multilateral development banks and private finance in blended finance facilities that multiply public finance. While initiatives like this represent concrete proposals to help expand capital flows to EM&DC's, the scale of current commitments and activities are still much less than what will be required.

Ensuring that governments pledge to mobilise $100 billion in climate finance to EM&DCs was one of the top goals of the UK's COP26 presidency.[9] Ahead of COP, the **Climate Finance Delivery Plan** was published, providing clarity on how and when developed countries would meet the $100 billion climate finance goal. Several countries also raised their existing commitments. There is acknowledgement and concern, however, that the $100 billion annual pledge has been announced, and missed, in the past. A similar commitment was first announced at COP15 in 2009.

The **World Economic Forum** hosted a session focused on mobilizing capital to accelerate development of critical industrial decarbonisation technologies such as hydrogen-based green steel, sustainable aviation fuel, and carbon capture, utilization and storage. At least ten times more needs to be invested in decarbonization technologies by 2030 than

7 An overview of how the BoE is greening its Corporate Bond Purchase Scheme is available here.

8 IEA "Financing Clean Energy Transitions in Emerging and Developing Economies," report available here.

9 See summary of those goals here.

in 2020 for our economies to meet their zero emission targets. It was also highlighted in multiple sessions at COP that mobilising capital flows for these critical technologies will require innovative financing approaches, transformative business models, and timely policy intervention to establish incentives for early movers. This is a massive opportunity for capital providers. Through bold public-private partnerships and strategic client engagement with corporates, financial institutions can transform commitments into capital flows.

There is growing support for the role of **Voluntary Carbon Markets** in mobilising capital towards projects that can help lower emissions. A number of new contracts were launched at COP by major exchange groups seeking to catalyse growth in the market. These will link to the guidelines and frameworks set out by the newly created Integrity Council for Voluntary Carbon Markets. At this point in time, however, the appropriate use of carbon credits as part of net zero plans remains a subject of debate, limiting adoption by corporates. Negotiations on potential carbon prices are ongoing behind the scenes, and the industry will be closely watching how these discussions play out.

NATURE AND BIODIVERSITY ARE THE NEXT FOCUS

A landmark deal was signed on November 2nd by more than 100 nations, pledging to end deforestation and land degradation by 2030.[10] This was followed swiftly by an announcement from 33 financial institutions with $8.7 trillion of assets under management that they would halt financing of **agricultural commodity-driven deforestation** by 2025. Nature is increasingly being recognised as a critical lever to mitigate climate change, and support delivery of net-zero targets.

Financial services firms will now need to develop capabilities to measure and monitor their activities' impact on deforestation and develop approaches to significantly reduce it. The deal follows the recent formation of the **Taskforce on Nature-related Financial Disclosures (TNFD)** and is ahead of the conclusion of the biodiversity COP (COP15) in Kunming, China in April, 2022. As interest in "E" agendas beyond Climate grows, management teams will need to balance and engage with the growing focus on nature and biodiversity. They need to help shape the emerging thinking on the topic, while maintaining momentum on climate in order to deliver on their commitments. As more countries commit to strengthen their national level net zero plans over 2022, the financial sector will play an important role in supporting and accelerating progress.

10 Details of the agricultural commodity-driven deforestation pledge are available here.

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