Climate Risk and Sustainable Finance Outlook for 2020

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Recognition of the risks and opportunities associated with climate change reached new peaks across financial markets in 2019. But where to from here? From big picture global forces right down to expected milestones in the Canadian financial sector, here are five big trends that will shape the climate risk and sustainable finance space in 2020:

CLIMATE CHANGE DRIVES GEOPOLITICAL RISK

Millions of people were mobilized to march for climate action on every continent over the course of 2019, often energized by youthful leaders, in protest movements on a scale not seen in decades.[1] Bleak outlooks on long term economic prosperity is often cited as a main concern among climate protesters aiming to get the attention of financial sector leaders to step up and protect both planet and profit. Climate change stories dominated the news cycle in many countries, and rose to the top of voter priorities in Canada's national election.

But the climate movement's growing momentum had the wind taken out of its sails at the end of the year as the annual intergovernmental meeting on climate – known as COP 25 – held in Madrid was widely seen as a washout. Major emitters other than the EU did not come to the table with greater ambition for cutting greenhouse gasses, and an agreement was still not reached on the fundamentals of a global carbon market despite marathon negotiations.[2]

The gap between citizen expectations and governmental action is set to widen in the year ahead as frustration mounts among the public, and governments grapple with policy responses to the complex climate transition. Financial institutions will be caught in the middle, trying to meet changing client expectations, reduce climate risk, remain in compliance, and drive new market opportunities opening up around climate adaptation and mitigation.

INVESTORS TIGHTENING CARBON FINANCE

The world's largest asset manager, BlackRock, kicked off 2020 by issuing their annual CEO letter from the President and CEO stating that "… we are on the edge of the fundamental reshaping of finance."[3] Investor-led initiatives have been recognized as driving corporate action to mitigate pollution and build resilience to a changing climate. For example, Climate Action 100+ is an investor initiative to ensure the world's 150 largest corporate greenhouse gas emitters take necessary action on climate change.[4] More than 370 investors with more than US$41 trillion in assets under management are

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1 Six million people join latest wave of climate protests. The Guardian. 27 September 2019. https://www.theguardian.com/environment/2019/sep/27/climate-crisis-6-million-people-join-latest-wave-of-worldwide-protests

2 Debrief for Canadian Financial Institutions on COP25 Outcomes. GRI. December 2019. https://globalriskinstitute.org/debrief-for-canadian-financial-institutions-on-cop25-outcomes/

3 A Fundamental Reshaping of Finance. Blackrock CEO Letter 2020. https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

4 Climate Action 100.

proactively working with issuers on concrete actions they can take to transition to a low carbon economy. Climate related shareholder proposals have doubled over the past five years and the percentage of investors voting in favor has tripled in this same period. This activity has mainly targeted energy producers and the financial institutions that lend to them.[5]

Some leading European financial institutions have stated that they will no longer insure, lend or invest in fossil fuel-based industries in order to decarbonize their portfolios. This has exacerbated the declining access to capital in the Canadian oil sands and other related industries with some international players pulling out in 2019.[6] But according to a recent study of the top 50 banks worldwide, investments in fossil fuels still vastly outweigh sustainable finance commitments.[7] The year ahead will be telling as to whether mainstream players will follow the sustainable finance leaders, or if it will be business as usual.

THE YEAR "TRANSITION" WILL BE DEFINED

Green and sustainable finance are some of the fastest growing segments globally, and 2019 was a stellar year. In green bonds alone, global issuance rose to US$250 billion (of which US$9.6 billion were from Canadian issuers) from US$170 billion the year before, and is projected to grow to US$1 trillion by 2022.[8] This does not include the cornucopia of other products such as green loans, green mortgages, green exchange traded funds (ETFs), among many others competing in the marketplace and directing urgently needed to capital to companies and projects that are helping lower carbon emissions and build resilience to extreme weather events.

Green products have mainly been labeled or certified against standards as being compatible with a 1.5 or 2 Degree Celsius decarbonization trajectory. As a result, this has largely excluded companies and projects related to fossil fuels which dominate today's energy mix and account for an important segment of the global economy – but have the world on track for up to 4 Degree Celsius warming. There is an urgent need to define a pathway to transition beyond fossil fuels, and evolve the energy sector and others dependent upon it toward a low carbon future in a just and inclusive manner. This is generally referred to as "transition" and work is underway to define a set of investment criteria that will help attract capital for critical innovation in this sector.

Canada is leading the way with the development of a Green and Transition Taxonomy under the auspices of the Canadian Standards Association (CSA)[9] and chaired by leading financial sector professionals. An express standard is expected by mid-2020 that will help open up a new segment in the green market – transition finance. Over time, this express standard is expected to evolve into a full standard as the market develops. The International Standards Organization (ISO)[10] has also announced its plans for a sustainable finance standard and has recognized the work underway in Canada in this area.

TCFD REPORTING AND REGULATORY DEVELOPMENTS

A growing movement of asset owners and managers are concerned that climate risk has not been accurately priced into the market, and that issuers are not adequately managing or disclosing climate related risk. In response to this, the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD)[11] issued a set of recommendations for voluntary and consistent climate-related financial risk disclosures in mainstream financial

5 Carbonomics: The Future of Energy in the Age of Climate Change. Goldman Sachs. December 2019. https://www.goldmansachs.com/insights/pages/carbonomics.html

6 High profile cases in 2019 included Zurich Insurance Group, Norway's sovereign wealth fund, and HSBC

7 How are banks doing on sustainable finance commitments? World Resources Institute. October 2019. https://www.wri.org/blog/2019/10/how-are-banks-doing-sustainable-finance-commitments-not-good-enough

8 Climate Bonds Initiative. https://www.climatebonds.net/

9 Standards Council of Canada. https://www.scc.ca/en/standards/notices-of-intent/csa/sustainable-finance-defining-green-taxonomy-for-canada

10 ISO TC/322 Sustainable Finance. https://www.iso.org/news/ref2350.html

11 TCFD Recommendations. https://www.fsb-tcfd.org/publications/final-recommendations-report/

reports in mid-2017. In a recent survey of sustainable investment professionals, one-third indicated have already incorporated the TCFD recommendations into their analysis, and a further quarter plan to do so in the year ahead.[12] These investors remain largely dissatisfied with the quality and uptake of reporting by issuers but recognize that the practice is still fairly new.

The year ahead will be critical for TCFD uptake – it will mark the third reporting cycle since the release of the recommendations and expectations are high that disclosure practice will reach new levels of quality by firms that have been using the framework over the past several years. In order for the practice to truly move mainstream and the reported data to be of greater utility to financial analysts, the uptake of the TCFD framework will need to spread significantly beyond the nearly 900 firms that had embraced it as of 2019.

The Bank of Canada first announced its concerns about climate risk affecting financial stability in May 2019, and by the end of the year its research program on the topic was defined. The Bank is working with its central bank peers in the Network for Greening the Financial System[13] in various workstreams ranging from sizing the risk, assessing transmission channels and supervisory practice. The Bank will develop several reference scenarios which should be available in 2020 and are a major milestone toward a potential climate stress test for Canadian banks.[14]

MARK CARNEY'S NEW JOB AND THE PATH TO COP 26 IN GLASGOW

After his tenure as Bank of England Governor, Mark Carney will take up his role as United Nations Special Envoy on Climate Action and Finance in January, and make a move back to Canada. He has said that he will kick off a decade of action on climate in 2020, with financial sector engagement at the center of the agenda.[15] A leading proponent of the TCFD framework, it is expected he will push financial institutions and banks for better disclosure on their investments in fossil fuels and carbon intensive sectors, and seek to speed up financial sector action on climate. It is anticipated that he will have a role to play in giving climate finance and private sector engagement a boost at the next international Conference of the Parties climate conference which will be held in Glasgow in November 2020, expected to draw ministers and heads of state from most countries and up to 30,000 attendees.

Known as COP 26, the Glasgow conference has been described as the most important climate change gathering since the Paris Agreement was signed by 197 nations in 2015. Five years after the landmark agreement, governments are due to review their carbon emission reduction commitments and align with scientific limits, while also increase funding for climate adaptation and resilience.

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12 Sustainable Investor Poll on TCFD Implementation. Global Sustainable Investment Alliance. December 2019. http://www.gsi-alliance.org/wp-content/uploads/2019/12/Global-Sustainable-Investment-Alliance-TCFD-Poll.pdf

13 Network for Greening of the Financial System. https://www.ngfs.net/en

14 Researching the Economic Impacts of Climate Change. Bank of Canada. November 2019. https://www.bankofcanada.ca/2019/11/researching-economic-impacts-climate-change/

15 Former Bank of Canada Governor Mark Carney Urges Canadian Financial Sector to Act Against Climate Change. CBC. December 30, 2019. https://www.cbc.ca/news/world/mark-carney-climate-financial-sector-1.5410968

GRI'S PRIORITIES FOR 2020

At GRI our priorities for 2020 will be to support the development of methods and approaches for climate risk management and assessment by financial institutions, to investigate how climate change is affecting credit risk particularly in housing finance, and to track the fast-growing sustainable finance market in Canada.

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