

SUSTAINABLE FINANCE AND CLIMATE RISK: OUTLOOK FOR 2021

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Author: Alyson Slater, *Senior Director, Sustainable Finance, Global Risk Institute*



As we emerge from a year of unparalleled disruption, we look ahead to a 2021 that will continue to be shaped by the global pandemic, pressing human health issues, and the ensuing economic fallout. Many points of connection and comparison have been drawn between the pandemic and another external risk of global proportions – climate change. From big picture global forces right down to expected milestones in the Canadian financial sector, here are the trends that will shape the sustainable finance and climate risk agenda in 2021.

1. COVID-19 INFLUENCES THE TRAJECTORY OF CLIMATE CHANGE

Government green stimulus programs aim to ‘build back better’ by de-risking investment in infrastructure and services that create jobs and achieve social or environmental outcomes.

The Canadian government, and many others around the world, are using pandemic recovery stimulus to ‘build back better’ and make historic investments in sectors like green energy and infrastructure to create jobs and achieve climate goals at the same time.¹ These programs have decade-long lifespans and are designed to leverage private finance as governments aim to attract investors and lenders into greener pastures. This poses an opportunity for financial sector firms to get involved in new and fast-growing markets such as building retrofitting and clean technology.

Heavy restrictions on travel worldwide in 2020 were a major factor in the reduction of greenhouse gas emissions

by an estimated eight per cent below 2019 levels. To put it in perspective, we will need to sustain these reduced emissions levels year-on-year for a decade to meet the targets that have been set to avoid the worst climate change impacts – but without the crushing economic blows that came with it in 2020. The year ahead will provide an opportunity to lock in some of the carbon-saving trends, such as increased remote work, and to leapfrog to green solutions, like electric vehicles, as we move into a post-pandemic new normal world.²

2. NET ZERO, NOW WHAT?

Ambitious yet long-term emissions reductions goals were set in 2020 by all major economies and some leading financial firms – 2021 is the time for concrete plans.

The major global economic players introduced new rules of the game in 2020 – the hard target is net zero carbon emissions by 2050. The European Union, the United Kingdom and Japan predictably announced their net zero targets in 2020. The world’s heaviest carbon emitter, China, announced that they would reach net zero by 2060. With United States President-elect Joe Biden’s intention to put the U.S. on an irreversible path to net zero by 2050³, the dominant global economies are accounted for. Canada followed suit with *Bill C-12: The Carbon Accountability Act* which is expected to pass in 2021, legislating net zero by 2050. This is in line with expectations under the Paris Agreement, signed in 2015 by 197 nations, where parties agreed to restrict the greenhouse gas emissions that cause global warming to levels that would limit temperature rise to 2 degree Celsius above pre-industrial levels.

There is pressure from investors, policymakers and clients on financial institutions to align their financed emissions with net zero targets, and many globally-influential banks and institutional investors have declared their commitment to this target. In Canada, TD and CDPQ were early movers, targeting net zero portfolio and operational emissions by 2050, and other top tier institutions are expected to follow in 2021.

2050 feels far away, but the systemic changes in our economy and daily life that will be needed to cut emissions are significant, as are investments in new green energy and clean tech industries now in nascent stages. The need for concrete net zero or low carbon transition plans is now urgent to fill in the blanks on these long-term targets and bring them to life in the immediate term. Government and industry will have to work in tandem to forge this path in 2021.

3. 'TRANSITION' IS THE NEW GREEN

The market for green finance will necessarily be overtaken by 'transition finance' — and 2021 will be a foundational year in the establishment of this market segment.

The global green bond market has been projected to grow to €1 trillion (\$1.5 trillion Cdn) this year from €300 billion (\$465 billion Cdn) in 2020, buoyed by the planned issuance of €225 billion (\$350 billion Cdn) worth of green bonds from the European Union. The market for green financial products is certainly booming, but investments in activities that are already low-carbon are not sufficient for Canada, and most other major economies, to meet their net zero carbon emissions commitments. Both public and private capital must flow toward activities and innovations that decarbonize existing high-emissions sectors, such as oil and gas, mining, agriculture, buildings, and transportation — this is known as transition finance.

The International Capital Market Association (ICMA) issued a Climate Transition Finance Handbook in late 2020⁴ that provides guidance to capital markets when raising funds in debt markets for climate transition-related purposes. To complement these principles, a series of transition

taxonomies are expected for release in 2021, notably in Canada, Japan and Australia, among others. A transition taxonomy is a classification system that specifies the business activities that shift carbon-intensive activities to become lower-carbon emitting, bringing standardized definitions as to what qualifies as eligible for transition finance. Taxonomies are one of the essential tools needed to drive capital toward green and transition activities.

Inspired by the recommendations of the Canadian Expert Panel on Sustainable Finance, the Canadian private sector is collaborating under the auspices of the CSA Group to develop a voluntary, market-based transition taxonomy, expected to be released in the first half of 2021. This is anticipated to lay the foundation for transition finance in Canada and beyond, and spark further work by policymakers, investors and industry to continually strengthen the transition finance market foundations.

4. CONSTRUCTING A GLOBAL CARBON MARKET

A private sector consortium will design a global voluntary carbon market in a major milestone toward reducing the risk of carbon price uncertainty.

The unpriced cost of carbon, and policy trajectory to address this externality, is one of the greatest sources of uncertainty for financial firms in climate risk assessment and management. Some firms manage the unpriced cost of carbon risk by valuating portfolio firms and other assets in scenarios wherein their carbon emissions range in price from \$50 to \$200 Cdn per ton or more.

A global carbon market and mechanism for pricing carbon is an inevitable part of what is needed for achieving the emissions reductions needed at the scale and pace required. This is a main component of the Paris Agreement, but after five years of negotiations, governments have not been able to break impasses and move forward on a set of rules for a new global system.

To fill the gap, the private sector has taken the lead and formed a consortium of experts, financial markets, standard setters and others in the Taskforce on Scaling

Voluntary Carbon Markets.⁵ Their market blueprint is due in 2021 and will allow entities to offset carbon emissions by financing projects that reduce or avoid emissions from other sources, or that remove greenhouse gases from the atmosphere. This is expected to help scale existing markets, promote alignment in carbon price policy, and trigger those firms committed to net zero to utilize carbon markets as an integral part of their emissions reductions strategy.

5. CLIMATE RISK MANAGEMENT AND REPORTING

Reporting on climate-related financial risks is here to stay, and climate risk management practice continues to mature with a focus on scenario analysis in 2021.

To help identify the information needed by lenders, underwriters and investors, to appropriately assess and price climate-related risks and opportunities, the Financial Stability Board (FSB) established in 2017 the Task Force on Climate-Related Financial Disclosures (TCFD) who issued reporting recommendations for use by all firms.⁶ GRI looked back on three years (2017-2019) of reporting by Canadian financial institutions and found a 40 per cent increase in disclosure aligned with the TCFD recommendations over that period.⁷ It is mainly the larger financial institutions that are reporting on the financial impact climate change will have on their business, including details on governance, strategy, risk management and targets. 2021 will mark the fifth year since the release of the TCFD recommendations and is a natural time to assess progress and effectiveness of the framework. Policy momentum has been seeded with New Zealand, the United Kingdom and Hong Kong mandating the use of the framework in 2020. More jurisdictions are expected to follow suit in 2021.

We will see significant advancement in the practice of climate risk scenario analysis in 2021. Scenarios are widely seen as a useful tool to assess the diverse yet plausible pathways we might take in terms of the physical impacts of climate change and impacts from the transition to a low carbon economy. The Bank of Canada and the Office of the Superintendent of Financial Institutions (OSFI) are

undertaking a pilot with six banks and insurance companies intended to build capacity for firms and regulators, and better understand the broader financial sector's resilience to transition risks. In the UK, the Prudential Regulation Authority (PRA) will use its biannual exploratory scenarios exercise to test the resilience of the current business models of the largest banks, insurers and the financial system to the physical and transition risks from climate change.

The maturation of climate risk management continues to accelerate in financial firms, but it is important to recognize that the integration of climate change into enterprise risk management will not automatically result in the reduction of financed greenhouse gas emissions. Climate risk management is about ensuring the business is aligned with the firms' risk appetite, and this may still include taking on carbon risk or other assets poised to be impacted under climate change. The alignment with climate risk management and net zero financed emissions targets can be a wide chasm to bridge, but will be the work of many financial firms in the coming period.

PRIORITIES FOR 2021

Our program priorities for the year ahead are to support our member firms as they advance sustainable finance and climate risk. These interrelated and fast changing issues pose both risk and opportunity for the Canadian financial sector. We will advance knowledge through our research, education and convening events with the following aims:

- Accelerate the integration of climate change into enterprise risk management and risk leadership in financial firms. Areas of focus are climate risk scenarios, TCFD reporting, and climate governance.
- Contribute to sustainable finance market development in Canada. Priority areas include transition taxonomy, green/transition strategy and finance, fiscal measures for emissions reductions.

2021 will be a milestone year for international cooperation on climate with the UK hosting the Conference of the Parties 26th annual meeting (COP 26) in Glasgow, and the fifth since the Paris Agreement was inked in 2015. This is the first time that there will be a specific call to action for the private sector, in the form of the COP 26 Private Finance Agenda⁸, which is designed to help private finance support the global economy transition to net zero greenhouse gas emissions. GRI will connect the Canadian financial sector to this agenda to share knowledge and exchange best practices with global partners.

ENDNOTES

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8. COP 26 Private Finance Agenda. <https://www.bankofengland.co.uk/events/2020/february/cop26-private-finance-agenda-launch>

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