ESG Credit Quarterly – 3Q21

Tangible Successes at COP26 Will Be Crucial for Global Climate Policy Momentum

'COP26 will begin with high expectations but against a backdrop of tight energy supplies and rising energy costs, likely undermining interest for steeper curbs to energy systems, especially coal, in the short term. Success in key areas, such as a time-specific commitment to meeting financing pledges, agreement on reducing methane emissions and a push for standardisation on voluntary carbon markets, can be key benchmarks of successes within the broader policy goals of the conference that lead towards global, coordinated policy actions.'

Marina Petroleka, Senior Director, Sustainable Fitch

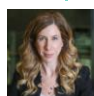
Related Research

Investors Grapple With Stemming Biodiversity Loss (September 2021)

New Japanese Policies Create Opportunities for ESG Bond Market (July 2021)

Enhanced Climate-Risk Disclosure Will Challenge Some US Corporates (October 2021)

Analysts



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Events Drive ESG.RS Deterioration - 9M21

ESG Relevance Scores (ESG.RS) changes coalesced around Governance issues in 3Q21, accounting for 31% of all score changes, driven by Corporates sectors. Deterioration in Governance scores in Financial Institutions (FI) were partly driven by government interventions in banking sectors in emerging markets, a trend we also highlighted in our 2Q21 report.

A review of ESG.RS changes over 9M21 shows that deteriorations in 'Exposure to Environmental Impacts' (EIM) scores for US public finance (USPF) issuers, due to the Texas freeze in 1Q21, and deterioration in 'Governance Structure' (GGV) scores for FIs over 2Q21, due to changes in ratings outlooks driven by events related to gaps in risk and control functions, are the two largest concentrations of score changes across all asset classes

Investors Prioritise Nature-Related Risks

Biodiversity and nature-related risks are rising in policy makers and investor agendas, with higher scrutiny and demands for clarity on impacts, targets and disclosures. While mechanisms for investors to influence biodiversity are often more limited than for such risks as climate change, new financial instruments and disclosure mandates could point to ways to incentivise state-owed and private companies to stem biodiversity loss.

Japan and US Prepare ESG Disclosures Steps

Japan, the US and the IFRS are all taking steps to enhance sustainability disclosures, particularly, though not exclusively, around climate. The first two are prominently, if belatedly, adding to the rising number of jurisdictions that are setting rules and regulations around sustainability disclosures. The impact of the International Sustainability Standards Board (ISSB), to be set up under the IFRS accounting standards, can be notable with the organisation expected to find broad based support in many markets where these standards are already widely adopted.

Tangible Successes Crucial for Policy Momentum Post-COP26

The bar is set high for the UN's 26th Conference of the Parties (COP26), with four major policy goals announced. These include the need to secure commitments by the parties on issues from coal phase out, to electric vehicle (EV) roll-outs and the USD100 billion in climate financing, in addition to all Paris signatories, and especially from G20, coming to the conference with updated nationally determined contributions (NDCs), or a pledge to update.

Sustainable Fitch has identified areas within these bigger goals that can be hallmarks of tangible successes and provide a brief assessment of what obstacles they may face. Success will move global cooperation on climate actions forward and mitigate policy failures that risk a divergence and disorderly transition to a low-carbon economy.

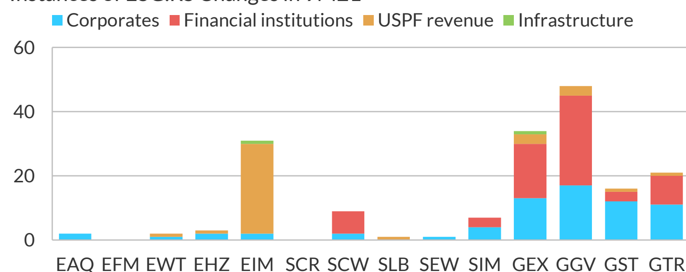
ESG.RS Review

Events Drive ESG.RS Changes in USPF and FIs

A review of changes to ESG.RS over 9M21 across Fitch's rated universe showed nearly 380 instances of score changes across 302 issuers[1]. The instances where scores deteriorated (in other words, when scores increased to indicate a higher rating impact – typically negative) were nearly equal to the number of instances where scores improved.

General Issues - ESG.RS Increasing to '4' or '5'

Instances of ESG.RS Changes in 9M21



Note: For a full list of abbreviations see Appendix
Source: Fitch Ratings

Slightly more than half of all changes in Environmental issues indicated a deterioration, most often to '4' from '3', suggesting that a general issue was having a material impact on the credit rating in conjunction with other factors.

EIM was the most frequently cited issue, with the highest concentration around USPF revenue-supported entities, specifically public power and water utilities affected by the extreme cold weather in Texas in February 2021.

With 27 instances of EIM scores deteriorating in USPF, this has been one of the highest concentrations among any asset class around a single general ESG issue in 2021, second only to deterioration in FI GGV scores in 2Q21.

Notably, there were also instances of an increase in Environmental scores, which drove a positive impact on the credit rating (+), in conjunction with other factors. These were driven by sustainable building practices, including green building certificate credentials (LEED Gold), that led to an uplift in EIM scores in two Structured Finance – CMBS issues in the US (280 Park Avenue Trust 2017-280P, and, CGCMT 2015-101A). As LEED accreditations become more desirable and prevalent in US commercial real estate, positive impacts on credit profiles may also become more frequent.

Clear and updated emissions reduction targets, divestment from coal fired power generation, reduced exposure to extreme weather were reasons for score improvements under the Environmental general issues. For instance, CEZ's (rating withdrawn in July 2021) ESG.RS in 'GHG Emissions & Air Quality' and 'Energy Management' was lowered to '3' from '4' following core ESG targets set by the company in May 2021. They are a reduction of average carbon footprint to 0.26 t/MWh in 2025 and 0.16 t/MWh in 2030, as well as in the share of coal-fired electricity generation to 25% by 2025 and 12.5% by 2030. CEZ will also build 1.5GW of renewables by 2025 and 6GW by 2030.

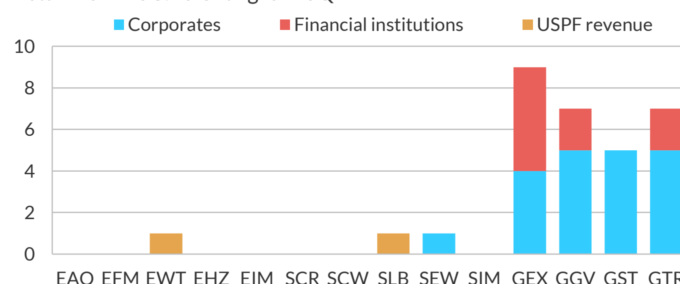
The exposure of sugar producer Tereos SCA (BB-/Stable) to extreme weather events remains relevant but is having little impact on the rating leading to the EIM score falling to '3' from '4'. At the same time, risks related to regulatory changes for application of crop protection products by farmers (previously captured under EIM) led to a re-assessment of the 'Waste, Biodiversity & Ecological Impacts' score to '4' from '3'.

Governance Remains Highly Relevant for Ratings

In 3Q21, there was a higher concentration of changes in scores around Governance issues, driven by deterioration in scores in Corporates and FI.

General Issues - ESG.RS Increasing to '4' or '5'

Instances of ESG.RS Changes in 3Q21



Source: Fitch Ratings

However, there were fewer instances of score deterioration in Governance than 2Q21, when score changes in FIs to '4' and '5' were numerous.

Over 3Q21, there was a higher number of Corporate issuers with a deterioration in their scores on Governance issues. This was driven by US electric utilities and subsidiaries of FirstEnergy Corp. (FE; BB+/Stable), specifically The Toledo Edison Company (BBB-/Stable), The Cleveland Electric Illuminating Company (BBB-/Stable) and Ohio Edison Company (BBB-/Stable). All of these had their ESG.RS for 'Management Strategy' (GEX), GGV, GST, GTR general issues raised from a '3' to a '4' to reflect material weakness in internal controls over FE's financial reporting and uncertainties associated with admissions included in FE's deferred prosecution agreement with the US Department of Justice. The latter has a negative impact on the credit profile and is relevant to the ratings in conjunction with other factors.

In FI, the deterioration of scores was almost entirely in issuers in emerging markets, notably changes to GEX scores to '4' from '3' for three banks in Argentina (Banco Macro S.A., Banco Santander Rio S.A., Banco BBVA Argentina S.A. (all 'CCC'). In all three cases the new score reflects the high level of government intervention in the Argentinian banking sector. The imposition of interest rate caps can lead to inadequate loan pricing and, together with the imposition of interest rates floors on time deposits, puts significant pressure on banks' net interest margins. Restrictions on fee levels can also negatively affect performance ratios. This challenges banks' ability to define and execute their own strategy.

[1] In some cases, an issuer or issue will have an instance of a score increase and decrease within the time period reviewed, but they are counted as unique instances of change as part of this review. Review also excludes new ESG.RS additions.

Heavier government interventions in the banking sectors and the subsequent deterioration in GEX scores for local banks was a continuation of a trend we had highlighted in our 2Q21 report for banks in Brazil, Bolivia and Turkey.

Fitch ESG Relevance Scores

Fitch launched ESG.RS for 1,534 corporate issuers in January 2019 and has since published more than 150,000 ESG.RS for more than 10,700 issuers, transactions and programmes across corporates, financial institutions, sovereigns, public finance, infrastructure, structured finance and covered bonds. The scores, which are produced by Fitch's analytical teams, transparently and consistently display both the relevance and materiality of individually identified ESG risk elements to the rating decision.

ESG.RS Scale

Score	Impact on credit	Description
1	None	Irrelevant to the entity, transaction or programme rating and irrelevant to the sector
2	None	Irrelevant to the entity, transaction or programme rating but relevant to the sector
3	Low	Minimally relevant to rating; either very low impact or actively managed resulting in no entity, transaction or programme rating impact
4	Medium	Relevant to the entity, transaction or programme rating but not a key driver; has a rating impact in combination with other factors
5	High	Highly relevant, a key rating driver that has a significant impact on the entity, transaction or programme rating on an individual basis

Source: Fitch Ratings

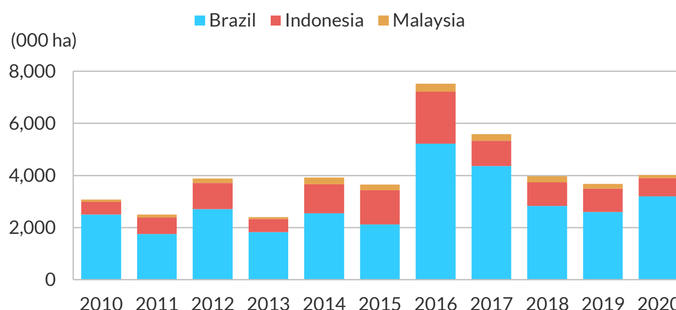
ESG Emerging Trends

Nature-Related Risks Rise in Investors' ESG Priorities

Nature-related risks and opportunities are broadly those posed by the linkages between an organisation's activities and nature[2], including activities that lead to the degradation of soil, sea and air resources, disruption to human and non-human ecosystems as well as alteration of ecosystem regimes. While the topic is often complex and nebulous, scrutiny and interest on this issue are rising among investors and policy makers, with some of the stated goals of COP26 being around curtailing deforestation, and protecting and restoring ecosystems. This is in addition to a separate COP15 on Biodiversity that also concluded its first phase in October 2021 in the Chinese city of Kunming, with Parties due to meet again for the second phase in April 2022.

Fitch addressed deforestation in depth in reports on deforestation and biodiversity[3], a phenomenon that is particularly acute in emerging market regions where forests are at risk.

Tree Cover Loss in Natural Forests



Source: Fitch Ratings, Global Forest Watch

The clearing of forests for agricultural and forestry use is still rising globally and contributes to increased carbon emissions and biodiversity loss. With the issue of emissions from agriculture coming under increasing scrutiny, the wider environmental footprint of producing agricultural commodities, such as soy, palm oil, beef and timber (notably in the case of illegal logging), can increasingly influence regulatory and investor scrutiny mainly in purchasing/importing jurisdictions.

Regulators, such as the EU, increasingly focusing on the agricultural sector and managing supply-chain risks of biodiversity loss and tropical deforestation, with the regulatory burden largely falling on buyers of biodiversity and forest-linked commodities.

While the issue of biodiversity preservation and loss mitigation is entering the mainstream, with wider recognition that nature-related risks are likely to materialise as financial risks across a range of industries and markets, there are still pertinent challenges faced by investors and stakeholders.

Some asset owners have taken to exclusionary screenings for soft and forest-risk commodities to mitigate the issue. Several large pension funds and investors have engaged in pressure campaigns on such companies, resulting in some significant corporate policy changes and, in some cases, government policy changes.

However, the issue remains fraught with difficulty, given that engagement with governments, state-owned enterprises and privately held companies is crucial for stemming biodiversity loss. Investors may be worried about perceptions that they are attempting to influence government policies. They also lack the means to hold private companies to higher scrutiny and accountability.

It is mainly banks – via loans, bonds and share issuance – rather than investors in capital markets that provide access to capital for commodity producers. In many emerging markets, local financial institutions often lack ESG integration policies or do not adhere to voluntary commitments on biodiversity. They are also the largest financiers of local producers, shielding them from the higher ESG scrutiny increasingly found in European and North American banks.

[2] Recommended definition of nature-related risks and opportunities by the TNFD – Nature In Scope, June 2021

[3] Investors Grapple with Stemming Biodiversity Loss, September 2021; Financial Sector Confronts Deforestation as a Key ESG Risk, September 2020

The establishment of the Task Force on Nature Related Disclosures (TFND), to build on the success of and complement the work of the Task Force on Climate Related Disclosures (TCFD), is an effort to provide investors, financial institutions, corporations and policy makers with a voluntary disclosure framework to report and act on nature-related financial risks. The TFND framework is expected to be delivered in 2023.

One of the stated goals of the TNFD is to "support a shift in global financial flows away from nature-negative outcomes and toward nature-positive outcomes", with the aim of providing a commonly accepted and adopted framework for higher levels of investor engagement, capital allocation and risk management.

It could also underpin the proliferation of sustainability loans and bonds, as well as such novel instruments as nature performance bonds, through objectives around stemming loss of biodiversity, mitigating deforestation or other nature-related objectives. These can be especially relevant for emerging markets. Some of the most acute nature-related risks are in these regions but they can also be the hardest to mitigate, from both economic and societal perspectives. Many emerging markets have a high proportion of debt denominated in foreign currency so soft commodity exports are important to the balance of payments and a high share of the population is engaged in primary economic sectors, mainly agriculture.

Regulations and Disclosures

Japan Catches Up on Sustainability Regulations

Policy makers and regulatory bodies have sustained their focus on climate and other sustainability-related corporate disclosures and policies to enable a path for more robust and standardised disclosures to emerge.

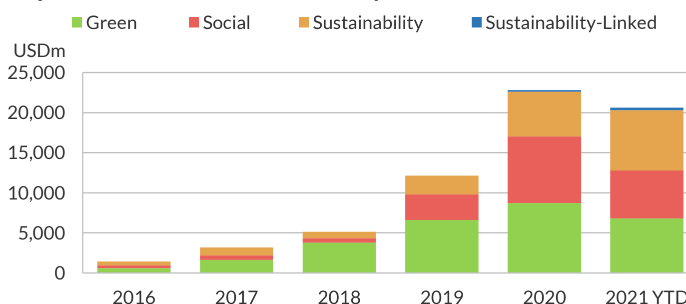
There have been notable moves by Japanese authorities. The Bank of Japan (BOJ) and the country's Financial Services Agency (FSA) have stepped up their efforts in the areas of climate change policies and corporate disclosures, respectively, bringing Japanese initiatives more in line with other jurisdictions.

Amendments to the Corporate Code of Governance by the FSA placed new requirements on listed companies regarding sustainability, and diversity and inclusion, effective from April 2021.

Then, in July 2021, the BOJ released its inaugural strategy on climate change, which addresses both its own role and that of Japanese FIs. The strategy has several pillars. Foreign-currency green bonds from non-Japanese issuers will become eligible for purchase as part of its foreign-exchange reserves. The central bank will also conduct climate scenario analysis for the largest Japanese banks and encourage them to make disclosures aligned with TCFD recommendations. Those that do will also have access to a new low-cost funding facility, with funds accessed through it must be used for green bonds or loans, sustainability-linked bonds/loans with climate change-related targets, and financing climate change transition efforts.

The BOJ joins other major central banks in adopting policies to promote efforts to address climate change and its new strategy brings it in line with climate-related policies recently introduced by the ECB and the Bank of England.

Japanese ESG Bond Issuance by Year



Source: Fitch Ratings, Bloomberg

ISSB and SEC Up the Ante on Sustainability Disclosures

This year will end with major announcements on the expected direction of travel around disclosures. Both the US Securities and Exchange Commission (SEC) and the IFRS will make announcements on climate-related standards and disclosures.

The ISSB is expected to be formally launched in COP26. The IFRS's move is intended to build on the work done by the major standard-setting bodies and the TCFD. It aims to develop a standard to capture financially material information about companies' sustainability-related risks and opportunities, and their impact on enterprise value, with an initial focus on climate-related risks.

Like the IFRS, the ISSB standards would be voluntary, unless national jurisdictions decide otherwise, but with large-scale adoption they may have the scope to become the *de facto* baseline in several markets. In our analysis on its prospects, we noted that the IFRS's credibility, entrenchment in accounting practices and familiarity would benefit the ISSB, that will be able to build on these elements to encourage rapid and large-scale adoptions of its standards.

The ISSB concept has been widely embraced by governments and regulators, including the G7 finance ministers and central banks, as well as the International Organization of Securities Commission (IOSCO). However, there are important uncertainties around adoption and adherence prospects, particularly relating to different definitions of sustainability in different jurisdictions and the extent of the trade-off between establishing a widely-accepted baseline and something of material substance.

One market where ISSB standards may face slower adoption would likely be the US, which is not a big adopter of the IFRS accounting standards. However, various initiatives in the US suggest that sustainability-related disclosures may become more prevalent, buttressing the overall ESG market and bringing the US corporate sector more in line with disclosures made by their peers in Europe and, to some extent, Asia.

US corporate issuance of green bonds, sustainability bonds and sustainability-linked bonds/loans could accelerate if the ESG Disclosure Simplification Act of 2021 passes the Senate and becomes law, as it would require public companies to disclose certain environmental, social and governance metrics. A uniform disclosure framework would help ESG investors adhere to investment guidelines by providing better transparency and comparability across issuers. It would also expand access to capital for issuers with exposure to greenhouse gas (GHG) emissions as assets dedicated to sustainable investing continue to grow.

The SEC is in tandem considering material revisions and updates to its 2010 Climate Related Disclosures, due to be announced by end-2021, with a view to strengthening and standardising disclosure by public companies. A consultation that concluded over the summer indicated broad support, but potential exposure to litigation risks under US securities laws for companies that file such information with the SEC is one of the concerns still to be addressed. This may be one of the dictating factor on whether the SEC decides these will be mandatory or voluntary disclosures, or on a comply-or-explain basis.

Fitch recently noted that regulatory enforcement of enhanced climate-risk disclosure by the federal government will challenge some US companies. US public companies have faced a much lighter regulatory pressure on disclosures than their European peers, so preparations and awareness are not as sophisticated. A Conference Board poll of more than 300 executives from 150 companies indicated 60% of them do not believe their organisation has a strong internal definition of sustainability.

Select List of Sustainability-Related Disclosures

Jurisdiction	Regulation	Disclosure topic	Company type	Framework	Disclosure type	Effective date
EU	Sustainable Finance Disclosure Regulation	Adverse impact - entity level and financial product level Environmental or social characteristics – product level	Asset managers		Mandatory	June 2021
	Corporate Sustainability Reporting Directorate	E: climate change; water; resource use; pollution; biodiversity	All listed companies		Mandatory	January 2023
		S: equal work opportunities; working conditions; human rights	All large companies (revenue > EUR40m, > 250 employees, assets > EUR20m			
		G: sustainability strategy; corporate culture and ethics; political lobbying; internal control and risk	Banks and insurance companies			
UK	PS20/17	Climate	Premium listed companies	TCFD	Comply or explain	January 2021
	CP21/17	Climate	Asset managers, life insurers, FCA-regulated pension funds	TCFD	Comply or explain	January 2022
US	NASDAQ Board Diversity Rule	Diversity	NASDAQ-listed companies including foreign companies		Comply or explain	January 2022
	SEC Climate Disclosure	E: Climate	All listed and SEC-regulated companies		TBC	TBC
		S: Diversity				
Canada	C-25	Board, senior management diversity	Governed under Canada Business Corporations Act		Mandatory	January 2020
Hong Kong	HKEX Listing Regulations	E: emissions; water, energy, materials use; natural resources; climate change	All listed companies		Comply or explain	July 2020
		S: employment policies including gender, age, turnover rates; health and safety; development, training; labour standards; community engagement				
		G: board ESG oversight; board ESG management strategy; anti-corruption				

Select List of Sustainability - Related Disclosures

Jurisdiction	Regulation	Disclosure Topic	Company type	Framework	Disclosure type	Effective date
Singapore	SGX Sustainability Reporting	Material ESG factors	All listed companies		Comply or explain	December 2017
		Policies, practices and performance				
		Targets				
		Sustainability reporting framework				
		Board statement				
	Guidelines on Environmental Risk Management for FIs	Environmental risk management approach	Asset managers	TCFD	Mandatory	July 2022
			Banks			
			Insurers			
Japan	Corporate Governance Code revisions	Board independence	Listed companies	TCFD, IFRS	Comply or explain	April 2022
		Diversity in human resources				
		ESG/sustainability management at board level				
	Bank of Japan Climate Change Strategy	Climate risk and stress testing	Banks participating in climate change fund provisioning measure	TCFD	Voluntary	2021 TBC

Source: Fitch Ratings

COP26 – Five Litmus Tests for Success

The recent IPCC report[4], released in August 2021, contained stark warnings about the state of warming of the planet and the impacts if warming exceeds 1.5°C, with responsibility placed entirely on anthropogenic GHG emissions. The report is expected to galvanise action from policy makers ahead of and during COP26, in a similar way that the previous IPCC report (AR15) on the eve of COP21 (Paris) is seen to have catalysed the adoption of the Paris Agreement.

Expectations ahead of the conference are high and the stated goals are ambitious.

COP26 Goals

1. **Secure global net-zero by mid-century and keep 1.5°C within reach;**

   Ambitious 2030 emissions reductions targets:

   - accelerate the phase-out of coal;
   - curtail deforestation;
   - speed up the switch to electric vehicles;
   - encourage investment in renewables.

2. **Adapt to protect communities and natural habitats:**

   Protect and restore ecosystems and build infrastructure and agriculture that is resilient.

3. **Mobilise finance:**

   Developed countries to make good on their promise to deliver USD100 billion in climate finance a year.

4. **Work together to deliver:**

   Finalise the Paris Rulebook and accelerate collaboration.

Source: COP26 -- https://ukcop26.org/

The success of the conference will be crucial to maintain the policy momentum that has been building globally towards achieving the Paris Agreement goal of maintaining warming well below 2°C to 2050 aiming at 1.5°C, and, achieve significant GHG reductions by 2030.

Within the context of the four major policy goals set out for COP26 (see Box above) we identify and briefly explain five areas of policy coordination that will be on the table and, for which, the extent of their adoption can be a litmus tests for the success of the conference and the continuing policy momentum behind efforts to meet the Paris Agreement goals.

We are aiming to highlight the likely outcomes or indeed likely obstacles to an outcome for each to provide broad benchmarks by which successes may be measured.

1. Climate Financing from Developed Economies to Developing – USD100 Billion a Year

This is a target that developed countries have not met and COP26 is an opportunity for them to reiterate their commitment and announce plans to act on it. The USD100 billion climate financing commitment from 2020 was introduced in COP16 (2009) and has been a central feature of the Paris Agreement. The objective is to provide financing to developing countries to help with climate transition and adaptation projects.

Aiming to create some momentum behind meeting this goal, US President Joe Biden has pledged to double US contributions by 2024, but his proposal will need legislative approval. However, the long-term commitment of the USD100 billion pledge, at a time of vastly increased government borrowing and debts following the Covid-19 pandemic, can make countries' commitment either waver or altogether continue not materialising.

A pragmatic outcome may be a bridge agreement, where developed countries commit to providing this funding via the UN Green Climate Fund, with a view to renewing this commitment in five years' time. A time-bound commitment, as opposed to a more open-ended or very long-term commitment, may be more palatable and crucially achievable for the countries that have pledged to contribute. Furthermore, UK newspaper *The Guardian* reported on 24 October that plans were being prepared for a proposal to meet the climate financing pledge by using an average of financing provided between 2020 and 2025 rather than an absolute yearly figure.

In addition, per the UN's assessment, the commitment does not distinguish between private and public sources of financing. With a rising tide of green bonds, green and sustainability funds and other labelled instruments entering the market, recognition of their potential role in contributing to this target may be a way to move towards achieving this goal. However, this may come with contentions based on country of issuance and concentration of capital markets activities in a few hubs around the world.

Given that for many countries the only way to meet their stated NDCs is by vastly increasing financial resources, technology transfers and technical cooperation, amongst other measures as per the UN's assessment, action on the USD100 billion pledge is seen as one of the litmus tests for success for COP26.

2. Increase in the Stringency of the NDCs as Per Prior Commitments

A binding commitment of the 2015 Paris Agreement is the pledge for each of the signatories of the agreement to increase the ambitions of their NDCs every five years, with COP26 marking the first five-year review and an objective to better align NDCs on a global level.

According to the UN Climate Change, NDCs contain information on targets, policies and measures for reducing national GHG emissions and climate adaptation measures.

[4] AR6 Climate Change 2021: The Physical Science Basis, IPCC, August 2021, https://www.ipcc.ch/report/ar6/wg1/

Getting all the major economies in the world to reiterate the pledge of a five-year review cycle of incrementally more stringent may be a realistic objective considering that several of the major economies may go into the conference with either weakened NDCs or even possibly without any updated submission.

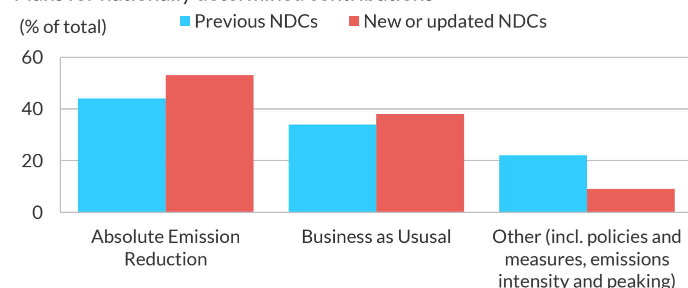
New or updated NDCs submitted for the NDC Synthesis report by the cut-off date of 31 July 2021 covered 59% of signatories to the Paris Agreement (113 out of 190), accounting for 49% of GHG emissions.

Considering that the IPCC report says a reduction in GHG emissions of nearly 50% is needed to prevent temperatures from rising above 1.5°C by 2050, the projections under the NDCs show likelihood for emissions to keep climbing to 2030, vastly narrowing the path to net-zero by 2050.

More specifically, according to the findings of the NDC Synthesis report, for a 50% chance of limiting warming to 1.5°C by 2050, NDCs (as they stand) would eat up nearly 90% of the remaining carbon budget by 2030, leaving a very limited carbon budget for 2030 and beyond. This shows how narrow the path becomes in the coming decades. The report warns than unless NDCs are significantly bolstered in the 2020s, attaining cost-optimal emission levels becomes much harder.

Mixed Progress on NDCs

Plans for nationally determined contributions



Source: Fitch Ratings, UN FCCC, Nationally Determined Constribtions Synthesis Report, Septmber 2021

While the NDCs may offer mixed signs of progress, a less prominent but equally impactful area where we may see progress is related to methane reductions. The latest IPCC report highlights the need to focus on non-CO_2 GHGs as well as the near-term potential of methane abatement to deliver on climate goals, given its short atmospheric half-life.

The Global Methane Pledge that stipulates reduction of methane emissions by 30% by 2030 from 2020 levels now includes nine of the world's top 20 methane emitters and there is growing momentum behind specific commitments at COP26. This would be in addition to measures announced by Canada, the EU and Nigeria to stem methane emissions from oil and gas operations, and supply chains.

3. Commitment to Phase Out Coal

As policy makers and world leaders head to Glasgow the rise in energy prices may test the limits of countries' commitments to progress on decarbonisation, specifically on the question of completely phasing out coal.

This may be especially the case for major users such as India and China, both of which are facing electricity shortages, with the former reportedly having a serious deficit in coal reserves (at time of writing) and the latter asking coal producers in the coal-rich region of Inner Mongolia to ramp up production to meet electricity sector needs according to a report by the Financial Times.

The question of a set, globally accepted date for phasing out unabated coal for electricity generation was already lacking consensus as shown by both the G7 meeting in June 2021 and G20 meeting of energy ministers the following month. China, India, Russia, Saudi Arabia and Turkey did not endorse language that committed to phasing out domestic coal use at the G20 summit, while Japan and the US resisted calls to agree to a specific date for coal-phase out at the G7 meeting.

Agreeing on a set date to phasing out domestic coal use was already one of the most ambitious and difficult goals for COP26. It was unlikely that the conference would be able to produce a breakthrough in terms of a global commitment to a specific date, but it may have been able to produce higher levels of consensus to limit financing of coal activities abroad -spurred on by China's recent commitment to do so - and a collective agreement to phase out coal without carbon capture and storage, or unabated coal.

Current conditions in the global energy markets and the impact from high energy prices can have on economies likely raises that difficulty further. It remains to be seen where the energy markets are as COP26 gets underway and what impact this will have on countries that were already reticent about, if not outright opposed to, phasing out coal rapidly from their energy systems.

4. Finalising the Paris Rulebook – Agreement on Article 6 of the Paris Agreement

Article 6 of the Paris Agreement, which sets out rules governing international carbon trading and 'voluntary cooperation' towards emissions reduction commitments, remains the only outstanding element to be agreed with regard to its implementation and functioning, owing to lack of agreement during the COP25 in Madrid in 2019.

In essence, Article 6 outlines broad aspirations for international trade in country-level emissions reductions 'over and above' Paris Agreement commitments, operation of a global carbon market in trade of emissions reduction credits in the private and public sector (replacing existing mechanisms that stem from the 1997 Kyoto Protocol) and a framework for non-market trade in emissions reduction, such as in bilateral overseas aid agreements.

The outcome of these discussions has become increasingly significant with the growth of voluntary carbon offset markets as a consequence of rising corporate net-zero or carbon neutrality commitments (see Tightening Voluntary Carbon Markets to Drive Up Costs). Growing concern around the integrity of projects financed by carbon offset credits has led to the development of the UK government supported Voluntary Carbon Markets Integrity Initiative. One of the concerns surrounding carbon offset projects is the so-called *additionality* of emissions reduction activities – or whether these activities would have occurred in the absence of the credit. This has been seen as a key deficiency in many international emissions reduction projects financed under the Kyoto-era Clean Development Mechanism.

It is this concern that has led to an impasse between countries on the operation of international carbon markets under Article 6 – specifically, whether emissions reductions financed by voluntary credits in the private sector should be able to be counted towards overall country-level commitments under the Paris Agreement, which has led to concerns around 'double counting' of emissions reduction pledges. A handful of countries that have been historically active in supplying emissions reduction or offset credits have demanded that these reductions should be included within origin country NDCs, leading to limited progress on negotiations on Article 6.

Given the rapid growth of voluntary carbon markets, the need for emissions reduction in hard to abate sectors and the potential flow of private capital from developed to emerging markets, agreement on Article 6 could galvanise international climate action, but appears unlikely to occur during COP26 given some of the opposing interests of key national governments at present.

A more likely outcome is the continued growth of standardisation and verification standards in voluntary markets coupled with a growth in bilateral agreements between countries on emissions reductions, such as those between Switzerland and Peru and Ghana, or Japan and Indonesia.

5. Accelerate Switch to Electric Vehicles (EVs)

Acceleration of the switch to EVs, one of the goals stated for the conference, is an area where significant momentum exists already and where governments and other stakeholders can commit, or reiterate their commitments, to specific targets.

This is an easier task than other areas where policy makers will have to seek agreement. On EVs, there is now very broad consensus on their adoption and with the auto industry fully geared towards an electric and alternative-fuel future, the prospects for large-scale switch to EVs look strong. Data by energy consultancy Wood Mackenzie indicate that global EV sales can reach six million in 2021, twice the amount of 2020, surpassing even the most optimistic projections at the start of the year.

Therefore, given the state of play in the alternative fuels vehicles segment we consider this an area of existing broad consensus.

Where policy makers can make a pledge to move policy forward is around the critical issue of financing charging/re-fuelling infrastructure build outs, while also considering how changes in existing support policies (e.g. tax credits, purchase subsidies) can undermine growth. It is also predominantly government entities that have control over the procurement of public transportation vehicles, and coordination between agencies can increase the adoption of low-emissions buses, trains, and trams. These are areas that we identified previously as being the greatest risks to stalling of the EV momentum (see EV Momentum Accelerates).

Wavering Policy Resolve Risks Fragmented Actions and Disorderly Transitions

Looking at the spectrum of possible outcomes from COP26, passing all five litmus tests would be a resounding success. However, if no notable progress is made on any of them, then this would undermine the efforts that individual countries and regions have been making in anticipation of higher levels of coordinated actions.

While neither of those scenarios is likely to materialise in full, the direction in which the pendulum swings based on the level of commitments that can be secured against each of these major areas will reveal the ultimate level of success of the conference.

A key risk with wide-reaching implications is if outcomes from COP26 are seen as underwhelming, with policy resolve from major signatories to the Paris Agreement wavering from their commitments, and specifically the 2030 commitments, which require more immediate and crucially, expensive, actions.

We reiterate that the repercussions of the current energy crisis can be detrimental to immediate commitments as policymakers are generally more responsive to short-term trends and pressure to relax some climate policy mechanisms (e.g. ETS allocations) could grow.

We have seen a variety of policy approaches from key emerging markets (e.g. China's 2060 neutrality target, 2030 emissions intensity goal). This reflects different development needs but also the economic structure of these markets; many fossil-fuel-dependent assets are much earlier in their operational lifespan so in the absence of financial support asset-stranding and just-transition concerns effectively act as a policy constraint on low-carbon transition.

Vastly unreconciled objectives between countries and stalling on momentum for more globally coordinated action can have several potential impacts, including, undermining corporate willingness to make expensive, low-carbon investments as there may be less of an incentive to be a first mover, especially in emerging markets. It could slow the momentum around low-carbon transition causing a stasis with divergence and fragmentation across regions in terms of pace and scope of decarbonisation. This could be problematic for investors as well as efforts towards some more universal form of climate-related disclosures and taxonomies, to channel financing towards activities that mitigate or help countries adapt to climate change.

Policy wavering, or appearing to waver, also carries higher risks of stricter regulatory changes later. This accentuates the regulatory policy gap between pledges, aspirations and actions to mitigate and adapt to climate change, raising the possibilities of disorderly transitions and adaption to climate change and climate risks.

Disorderly transitions are also identified as a systemic risk to global financial markets. Central banks (in their NGFS - Network for Greening the Financial System-scenarios) and regulators continue to highlight that potential financial disruption globally is minimised under orderly transition scenarios. Disorderly scenarios point to far greater financial climate-related costs. Short-term financial transition-related costs faced by companies (as they invest to adapt) and banks (as they encounter increased loan defaults) are far lower than the cost of acting too late.

Appendix

ESG.RS Definitions

General Issues Abbreviations with ESG.RS Increasing to '4' or '5' Charts on page 2

Environmental

EAQ: GHG Emissions & Air Quality

EFM: Energy Management

EWT: Water and Wastewater Management

EHZ: Waste, Biodiversity & Ecological Impacts

EIM: Exposure to Environmental Impacts

Social

SCR: Community Relations & Social Access

SCW: Customer Welfare, Product Safety, Data Security

SLB: Labour Relations and Practices

SEW: Employee Well Being

SIM: Exposure to Social Impacts

Governance

GEX: Management Strategy

GGV: Governance Structure

GST: Group Structure

GTR: Financial Transparency

Related Research

Investors Grapple with Stemming Biodiversity Loss (September 2021)

New Japanese Policies Create Opportunities for ESG Bond Market (July 2021)

Where ESG Matters for Bank Ratings (July 2021)

ESG Disclosure Law Would Aid US Corporate Sustainable Debt Issuance (July 2021)

Enhanced Climate-Risk Disclosure Will Challenge Some US Corporates (October 2021)

ESG in Credit – Biodiversity and Waste Issues (April 2021)

Financial Sector Confronts Deforestation as a Key ESG Risk (September 2020)

Rating Action Commentaries

Fitch Revises FirstEnergy & Subsidiary Outlooks to Stable from Negative on DOJ Settlement (August 2021)

Fitch Revises Tereos's Outlook to Stable; Affirms IDR at 'BB-' (August 2021)

ESG.RS Tools – 3Q21

Structured Finance and Covered Bonds ESG Relevance Heatmap – 3Q21 (October 2021)

Structured Finance and Covered Bonds Interactive ESG Dashboard – 3Q21 (October 2021)

Structured Finance and Covered Bonds ESG Sector Discovery Tool – 3Q21 (October 2021)

Public Finance and Global Infrastructure Interactive ESG Relevance Dashboard – 3Q21 (October 2021)

Public Finance & Global Infrastructure Interactive ESG Relevance Heatmap – 3Q21 (October 2021)

Public Finance and Global Infrastructure ESG Sector Discovery Tool – 3Q21 (October 2021)

Financial Institutions ESG Relevance Heatmap – 3Q21 (October 2021)

Financial Institutions Interactive ESG Dashboard – 3Q21 (October 2021)

Financial Institutions ESG Sector Discovery Tool – 3Q21 (October 2021)

Non-Financial Corporates ESG Relevance Heatmap – 3Q21 (October 2021)

Non-Financial Corporates Interactive ESG Dashboard – 3Q21 (October 2021)

Non-Financial Corporates ESG Sector Discovery Tool – 3Q21 (October 2021)

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