COP 27 Climate Conference – Key Takeaways and Potential Investment Implications

By Emily M. Berger, CFA, Director of Investment Risk Advisory, Financial Services

As experienced investors know, significant geopolitical and macroeconomic events are important to understand in calibrating your investment risk strategy for the upcoming year. The recent 27TH Conference of the Parties (COP 27) led to material agreements between the participating nations across various different work streams for the ultimate goal of working together to reduce global warming to 1.5C degrees through the reduction in greenhouse gas emissions.

This article distills the key takeaways of COP 27 and potential investment implications of the developments and agreements reached by participating government officials and corporate leaders during the event.

Key Takeaways

- **Considerable discussion, negotiation and the creation of a "Loss and Damage Fund"** but no firm agreement on the structure or mechanics. A transition committee will be appointed to iron out the details of the funding arrangements during the upcoming year. While there generally is consensus that smaller, low-emission countries need financial assistance to recover from catastrophic weather events, developed nations view a "Loss and Damage Fund" as a spiraling liability that is difficult to manage. Since major greenhouse gas emitters, China, India, Brazil and Indonesia, are still classified as developing countries, they will not be required to contribute to the new "Loss and Damage Fund" which seems to contradict the spirit of the new facility.

- **Launch of the Global Shield against Climate Risks (Global Shield)** by the G7 countries and the Vulnerable 20 Group of Finance Ministers (V20) to function as a new insurance system with pre-arranged financial support for vulnerable countries recovering from climate disasters. The Global Shield will serve as a financing solution for adaptation, resilience and disaster transfer risk. To date, the vast majority (€170MM) of the €210MM in funding has been provided by Germany, with additional support from other countries, such as Denmark, France, Canada and Ireland among others. The initial recipients of funds will be Bangladesh, Costa Rica, Fiji, Pakistan, Philippines, Ghana and Senegal.

- **The International Sustainability Standards Board (ISSB) announced a new partnership with the Carbon Disclosure Project (CDP)** in which the newly developed and nearly finalized IFRS S2 Climate-related Disclosures Standard (IFRS S2) will be incorporated into CDP's existing questionnaires and disclosed through their platform of 18,700 companies. Current plans call for the new corporate disclosures on the CDP platform to launch with the 2024 disclosure cycle, on a voluntary basis. The new IFRS S2 seeks to provide a global baseline for consistent and comparable information across companies/sectors and is expected to be finalized in 2023. The disclosures will focus on a company's governance, strategy and risk management and the metrics and targets used by the company to measure, monitor and manage its significant climate-related risks and opportunities.

- **Progress on methane emissions** as the United States announced restrictions on methane, a potent greenhouse gas. The U.S. Energy Protection Agency (EPA) announced plans to require all oil and gas companies to monitor existing production facilities for methane leaks and repair them. The EU signed an agreement with the U.S., Japan, Canada, Norway, Singapore and the UK to develop an international market for fossil energy that minimizes methane and carbon dioxide emissions and minimizes flaring, to the extent possible, across the value chain. In a surprise announcement during COP 27, China described a plan to reduce methane emissions along the oil and gas supply chain and those generated by agriculture and urban waste as well as improving the country's methane monitoring systems. However, China made no mention of emissions generated by coal mining, a major source of methane emissions for the country.

- **Little progress on improved ambition in Nationally Determined Contributions (NDCs)** although the EU, Mexico and Turkey announced their increased commitments during the conference. NDCs are the main vehicle created by the Paris Agreement for countries and regions to define their climate action plans to cut emissions and adapt to climate impacts.

- **Strategic alliance formed between the three largest rain forest nations, Brazil, Indonesia and Congo**. This new alliance seeks to coordinate and protect their forests, which comprise more than half of the world's tropical forests.

- **Increased participation by more countries in the High Ambition Coalition for Nature and People (HAC).** HAC is an intergovernmental group of 112 countries which collectively champion the protection of at least 30% of the world's lands and oceans by 2030, known as the "30 x 30" target, to help curb biodiversity loss and climate change.

- **Creation of the African Carbon Market Initiative (ACMI)** which seeks to dramatically expand Africa's participation in voluntary carbon markets and to support the growth of carbon credit production and job growth in Africa. The ACMI launched during the COP 27 conference with the ambition to reach 300 million carbon credits produced annually by 2030. Multiple African nations pledged their support for the effort, including Kenya, Nigeria, Malawi, Gabon and Togo.

- **Approval for vulnerable countries to add new climate resilient debt clauses (CRDCs) to future bonds issued in international markets**, which will enable issuers to defer sovereign debt repayments up to two years in the event of certain pre-defined natural disasters.

- **Productive discussion about innovative financing structures to assist with climate transition, including opportunities for blended finance, debt-for-climate swaps, among others.** The final COP 27 agreement called for multilateral development banks (MDBs), such as the World Bank, to reform their priorities and drive and support capital flows for mitigation and adaptation efforts against the impacts of climate change. Blended finance opportunities that combine concessional public funding for the equity risk in climate-related mitigation to incentivize private capital and lending in those projects have increased traction and provide essential financial support to developing countries.

Where Might This Lead? Implications for Investment Portfolios

- **There was significant discussion at COP 27 regarding the need for capital to flow to developing and emerging market countries** which continue to suffer significantly from the effects of climate change and lack the resources to handle the challenges.

    - **Increased investment in emerging market countries will strengthen their currency** as capital flows in and to the extent their currencies are pegged to the U.S. dollar, strengthen the U.S. dollar. Many in the institutional investment community regard emerging markets investments as a leveraged play on the U.S. dollar.

- **The unification of climate risk reporting standards through the International Sustainability Standards Board (ISSB) will provide investors with actionable data which can be incorporated into investment and credit underwriting decisions.** The most likely starting point will be the incorporation of physical risk and transition risk forecasts into valuation and default probability models, particularly for those companies with a significant real estate or manufacturing footprint.

- **Positive revaluation of assets previously considered illiquid and written down, such as certain natural assets.** This could represent a new valuation mosaic which considers certain commodities a scarce resource which must be allocated in a careful manner.

- **Further support and tailwinds for investments in renewable energy** provided that supply chain shortages can be resolved in a timely manner.

- **Noise regarding greenwashing through transactions from public entities which will be pushed to disclose their carbon emissions from a regulatory perspective to private entities or countries where these disclosures are not mandated.**
    - Required knowledge for investors to understand the implications of carbon valuation on portfolios, beyond the obvious candidates impacted by climate change, such as real asset investments in private energy and real estate.

We continue to monitor the potential investment risk implications of the quickly evolving climate risk and carbon measurement disclosures required by global regulatory entities.

Contact Us

Please contact us for assistance in understanding the implications of these developments on your business and for external assurance and consulting on your public sustainability disclosures. For more information, contact your Client Engagement Partner or:

Emily M. Berger, CFA
Director of Investment Risk Advisory, Financial Services
646.699.2914 | eberger@pkfod.com

Matt Orrell
Partner, Financial Services
781.226.2331 | morell@pkfod.com

Marc L. Rinaldi, CPA
Partner-in-Charge, Financial Services
646.449.6309 | mrinalid@pkfod.com