UNFCCC Standing Committee on Finance

Call for evidence: information and data for the preparation of the fifth Biennial Assessment and Overview of Climate Finance Flows and Call for inputs: definitions of climate finance

Response by David Rouch[1]

This response is made as an individual in a personal capacity.

1.1 Those familiar with my work have encouraged me to make this response.

1.2 I am an international financial services lawyer and became a partner in Freshfields Bruckhaus Deringer in 2004 working from the firm's London office. I have advised the full range of finance operators, dealing with many of the world's leading financial services regulatory bodies. I am especially known for my work on law, finance practice and sustainability. I was recently the lead author of 'A Legal Framework for Impact: Sustainability Impact in Investor Decision-making' (https://www.unpri.org/download?ac=13902), commissioned by the UNEP FI, PRI and The Generation Foundation and published by Freshfields Bruckhaus Deringer in July 2021 ('**A Legal Framework For Impact**'). The report is relevant to the call for evidence and the call for inputs. Its principal focus is institutional investment, but the framework it provides would also apply to finance operators more broadly. I have been engaging with finance operators and policymakers on the report since publication and it is out of those discussions that I have been encouraged to make this response. I am also the author of 'The Social Licence For Financial Markets: Reaching For The End And Why It Counts' (Palgrave Macmillan 2020) which looks at how to galvanise behaviour change in financial markets and the role of law in that.

1.3 Although the closing date for responses to the *Call for inputs: definitions of climate finance* has now passed, this response covers both that and the call for evidence on climate finance flows. Among other things, this is because the latter tends to assume some clarity on the concept of 'climate finance'. That said, there are places where it too appears to be seeking further clarity, for example, the request for information on, 'Definitions and approaches used … to report climate-related finance flows.'

2. What are finance flows consistent with a pathway toward low greenhouse gas emissions and climate-resilient development?

2.1 Broadly, there are two sorts of finance flows that can be consistent with this pathway (the 'Paris Pathway'):

- Finance provided by public or private investors in or financiers of public or private enterprise where it is used to fund activities that are aligned with the Paris Pathway;
- The use by public or private enterprises of their own funds in support of their activities to the extent those are aligned with the Paris Pathway.

2.2 Again broadly, activity of a given public or private enterprise should not generally be treated as aligned with the Paris Pathway simply because the relevant activity, considered in isolation, is so aligned. It needs to be considered against the activities of the entity as a whole. For example, it is questionable whether funding for a windfarm should be treated as aligned with the Paris Pathway if the climate trajectory of the enterprise creating the wind farm is continuing to deteriorate and the relevant investment is not part of a strategy to change that.

2.3 The real question in establishing whether finance flows are consistent with the Paris Pathway is therefore whether that finance is being used in ways that result in public and private enterprises, in broad terms, **reducing their negative impacts on progress towards the Paris goals and increasing their positive impacts**.

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- From the point of view of finance use by the enterprises concerned, this involves an assessment of their changing climate impact, including the contribution to that of the way in which they use their funds to change that (any activity of a public or private enterprise is, in a sense, 'funded' so that the more Paris Pathway aligned those activities become, in a sense, the greater the finance flow towards the Paris Pathway).
- From the point of view of investors and other finance operators, it involves an assessment of whether those investors and finance operators are discharging their legal duties to those on whose behalf they hold or invest funds in ways that are intended to bring about **assessable reductions in the negative impacts on progress towards the Paris Agreement goals of enterprises with which they have an investment/finance relationship and increasing the positive impacts of those enterprises**.

2.4 Especially from the point of investors and finance operators, it is essential to recognise that simply channelling funding (a) towards activities that, considered in isolation, might appear consistent with the Paris goals and (b) away from those that are not, may not have any positive impact in terms of achieving the Paris goals. For example, divesting from a listed company with a highly negative climate trajectory will not necessarily result in any change to that trajectory, especially if the market for its investments is liquid. A growing body of evidence suggests that effective climate engagement and stewardship by finance operators with those they finance and invest in may often be much more effective in securing a use of capital by public and private enterprises that is increasingly aligned with the Paris Pathway.[2] This is not to suggest that there is no merit in seeking to measure changes, specifically, in the provision of capital to fund activities that are aligned with the Paris Pathway. However, it is also important to capture, for example, a flow of capital to an institutional investor that is actively and effectively committed to stewardship and engagement aligned with the Paris Pathway or changes in capital allocation within an enterprise (i.e. where the capital is not provided externally) which result in a similar alignment since the redeployment of existing capital is a substantial part of the challenge.

2.5 This response concentrates on the role of institutional investors and other private finance operators in securing alignment of public and private enterprise with the Paris Pathway. Here, the core need in assessing the extent to which finance is becoming aligned with the Paris Pathway is to move the focus beyond activities that have tended to be described as 'ESG' to establish how far finance activities are intended to have an assessable positive climate impact. In other words:

(a) beyond finance operators adjusting their business operations and financial strategies:
   - to mitigate and make them more resilient in the face of risks posed to them by climate change; and
   - to exploit opportunities to profit from tackling climate change;

(b) further towards finance activity that also:
   - recognises:
      - the system-wide or **'systemic' threat** posed by climate change to the health of the economies and markets on which finance operators rely to achieve their goals; and
      - the fact that system-wide challenges require a **collective response** to which finance operators are potentially integral;
   - involves finance operators taking **intentional steps** to have an **assessable positive impact** on the root causes of those risks thereby improving the chances of a more beneficial operating environment for those operators and more widely;
   - reflects the fact that achieving positive impacts of this sort does not rely solely on **capital allocation** decisions by finance operators, but also involves them **stewarding their relationships with or influencing** (i) the businesses which they finance, invest in or service (thereby affecting capital allocation ***within*** those businesses) and (ii) other third parties whose activities may align with the impacts they are seeking.[3]

[2] See Part A.1 of *A Legal Framework for Impact*, para 33 et seq. at p.28.

[3] Policymakers often emphasise the need for finance operators to allocate capital to business initiatives that address climate change. However, as discussed above, a significant part of the 'private investment' challenge of meeting climate goals does not concern direct investment of this sort, but the ***reallocation of investment***

2.6 The approach described at (a) above can be thought of as '**outside-in**' since it involves finance operators changing to position themselves as best they can in response to climate change. It is the focus of much current ESG activity. The approach described at (b) is '**inside-out**' since it involves finance operators contributing to collective attempts to head off underlying climate risks themselves. Activities that are essentially 'outside-in' may contribute to addressing these underlying risks in some way, but that is not their main purpose.[4]

2.7 GFANZ is a key attempt to help the finance sector to make this transition since signatories to the constituent alliances commit to take steps to secure behaviour change among economic actors which is intended to tackle the root causes of climate risk.

3. Greater conceptual and practical clarity to increase and assess finance flows that are aligned with the Paris Pathway

3.1 Greater conceptual or practical clarity is still needed in various areas (a) to enhance financial sector effectiveness in supporting the realisation of the Paris goals or (b) to develop finance regulatory frameworks that can help with that. Five are highlighted below. Some might initially appear relatively theoretical. However, all are important in practice. In each area there are implications for how regulatory measures are drafted and regulation operates. In some cases, regulation can also be used to support finance operators in generating practical clarity on some of the measurement challenges touched on in the SCF's call for evidence. Finance operator alliances such as those under the GFANZ umbrella provide important fora within which some of this work can be undertaken, and the level of effective engagement in alliances of this sort may help to provide an indication of how far finance flows are aligning with the Paris Pathway. This was the approach taken in A Legal Framework for Impact in seeking to estimate the proportion of global assets under management by institutional investors being managed in a way that involves pursuing positive sustainability impacts, not just 'outside-in' ESG investment approaches.[5]

A. Clarity about the different goals of policymakers and finance operators as they concern the Paris goals

3.2 Clarity about policymakers' and finance operators' goals, and in what ways the goals of the latter do or should involve steps to secure alignment with the Paris Pathway, is crucial. Currently, policy and industry commentary sometimes seems hazy about this.

3.3 The relationship between two sets of goals needs particular focus:

(a) the goals of the Paris Agreement; and

(b) the goals that finance operators are required or permitted to pursue by law.

3.4 All concerned need to understand in broad terms how far (b) aligns with (a) – see B below. Among other things, that is because finance operators are legal vehicles. The law sets the framework for and limits on their activities: they are only permitted to function in ways consistent with their legal design, and that may affect how far they can pursue decarbonisation goals (including, for example, how far they can do so in decisions on how to deploy their capital and whether other options such as stewardship and engagement with investee enterprises may be a more suitable option).

3.5 Often there may be alignment between 3.3(a) and (b) (e.g. see C below). However, where not:

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within existing business enterprises. Investment in businesses by finance operators is not necessarily, on its own, the most effective way for finance operators to ensure that private investment is directed towards achieving climate objectives. Their role in stewarding relationships with business enterprises, so influencing the allocation of investment within those enterprises, also needs attention.

[4] For more on this distinction in institutional investment markets see Part A.1 of *A Legal Framework for Impact*.

[5] See Part A.3 of *A Legal Framework for Impact*.

- Policymakers need to decide whether to bring greater alignment by (a) amending the basic duties of finance operators or (b) altering their operating environment to make activities supporting desired policy outcomes more consistent with existing legal duties; and
- Finance operators need to be careful not to exceed what is legally permissible based on the legal structure they operate from.

B. Clarity about the circumstances in which finance operators' legally defined goals may align with Paris Agreement-related goals – pursuing Paris goals where that is instrumental in achieving financial goals and pursuing Paris goals as an end in itself

3.6 Having understood the different nature of policy and finance operator goals, it is also important to be clear about the circumstances in which Paris Agreement-related goals of finance operators (within the scope of their legal goal frameworks) may align with those of policymakers who are concerned to achieve the goals of the Paris Agreement.

3.7 The precise legal position of different sorts of finance operator varies. However, very broadly, most currently operate under legal frameworks that, essentially, are likely to require them:

(a) to prioritise the goal of generating or maintaining financial or investment value; and

(b) to do so, sometimes, largely to the exclusion of other goals (including climate goals) unless realising those other goals is **instrumental** to achieving (a).[6]

3.8 Consequently, as the legal duties of finance operators stand, if policymakers want finance operators to undertake activities aligned with the goals of the Paris Agreement they either need:

- to ensure that achieving those goals is **instrumental** to generating or maintaining financial or investment returns, and to help finance operators to understand why that is the case (since it may not always clear at present), or
- to extend the circumstances in which finance operators are required or permitted to undertake activities aligned with policy goals as '**ultimate ends**' in their own right, in parallel with financial goals, so that these include steps aligned with the goals of the Paris Agreement.[7]

C. Clarity about risks posed by failure to achieve the Paris goals to financial goals that finance operators are often required to prioritise – especially the threat to the economic systems on which finance operators and markets depend to generate returns

3.9 As noted at 2 above, the focus of much sustainable finance activity and regulation has hitherto been 'outside-in'. While that is changing, especially in response to the decarbonisation challenge, there is a need for greater focus on finance operators taking steps to tackle the root causes of climate risks – 'inside-out' activity.

3.10 The threat from climate change to the performance of the economic systems on which finance operators rely is increasingly clear. So, based on the financial goals those operators are generally legally required to prioritise, many should have an interest in the root causes of that risk being successfully addressed as should regulators with systemic stability, finance operator resilience or consumer outcomes objectives.

3.11 Hitherto, consistent with the outside-in approach, a key means of seeking to mitigate the risks of dealing with or investing in third parties has been to create a diversified portfolio of assets or business model. This reflects modern portfolio theory and can help an asset owner, for example, in mitigating the risks to which a particular investee might be exposed because of how they run their business (i.e.

[6] As noted, the legal position varies between finance operators. Some have more flexibility in pursuing wider goals. In the case of institutional investors, see Part B.3 of *A Legal Framework for Impact*.

[7] For a more on this distinction between 'instrumental' and 'ultimate ends' activity in institutional investment, see Part A.1 of *A Legal Framework for Impact*.

idiosyncratic risks). However, diversification does not protect from the threats posed by declining sustainability to the economic systems that finance operators rely on to generate financial value. That requires action that will have a **positive impact** in reducing the threats themselves, so protecting those systems.

3.12 Finance operators are among those potentially able to achieve or encourage positive impacts of this sort. That is because they finance, invest in and service third parties whose economic and consumption activities contribute to climate change, but are also in a position to influence them. In other words, there is potential for finance operators to change not just their own direct climate impact, but also to have a positive influence on that of others. As noted above, they can do this specifically through their funding decisions. However, importantly, their financial position also enables them to exert pressure for investee enterprise alignment towards the Paris Pathway through their stewardship and engagement activities, resulting in a changed use by investee enterprises of their capital, effectively constituting a climate-related finance flow.

D. Clarity about what positive impacts finance operators can pursue that are consistent with achieving the Paris goals (where aligned with their duties), and how – including assessment methodologies

3.13 Legal and regulatory rules generally operate by reference to an intended outcome. However, how far a given outcome is achieved (and, hence, the effectiveness of the rules) depends, in part, on the circumstances in which those subject to the rules seek to comply. For example, a finance operator might conclude that it would be desirable to take a given step to comply with its legal duties but find that the detailed information it needs may not be available or may be too expensive to acquire.

3.14 To help finance operators towards the outcomes contemplated by legal and regulatory rules as far as this concerns the goals of the Paris Agreement, it is therefore necessary to help them resolve, essentially, three sorts of practical pinch points:

- **Clarity about impact goals**: the need for clarity about what practical steps finance operators can realistically pursue to secure change in third party behaviour aligned with the goals of the Paris Agreement (where consistent with their legal duties);
- **Clarity of information relevant to the Paris goals and impact assessment**: the need for greater clarity about the climate footprint of those who receive finance, investment and services from finance operators and how their progress towards impact goals relevant to Paris Agreement targets can be understood and assessed (i.e. in terms of changed behaviour); and
- **Clarity about finance operator contribution**: the need for finance operators to be able to understand what difference their involvement has made to any behaviour change by third parties.[8]

3.15 There may be greater clarity on some of these in the context of climate change than for other major sustainability challenges. However, it remains a work in progress and this has important implications for the SCF's attempts to measure and assess climate finance flows since the necessary consensuses and methodologies are not always available and assessment cannot always be reduced simply to numbers.

3.16 Regulators cannot resolve these challenges alone since they are principally matters of industry and specialist expertise and consensus, as seen with the development of sustainability reporting regimes (themselves part of the necessary infrastructure here). However, regulators can still help by:

- Encouraging a rigorous focus on these areas by finance operators in their business, for example, using various forms of 'process regulation', among other things, reducing inadvertent 'greenwashing' risks and incentivising finance operators to devote attention to developing the necessary expertise;
- Ensuring a good level of market discipline concerning finance operators' climate claims, including those relevant to the goals of the Paris Agreement, for example, using transparency, labelling and

[8] For more on this in the context of institutional investment, see Part A.2 of *A Legal Framework for Impact*.

performance reporting regimes, going further than the EU's Sustainable Finance Disclosure Regulation to distinguish clearly between:
    - those that involve intentionally pursuing positive climate impacts (an area where current disclosure regimes are weak);
    - those that apply various sorts of screening or selection to include or exclude exposures to commercial activities based on climate criteria (whether for financial or 'ethical' reasons or otherwise); and
    - those that do not do either.
- Facilitating the development of enabling frameworks for finance operators to pursue climate impacts, for example: (a) by strengthening corporate disclosure regimes in areas relevant to climate change, (b) by using convening or funding power to encourage work by industry, specialist and cross-disciplinary groups to articulate good practice standards in defining and assessing progress towards climate impact goals (as seen in the context of GFANZ), and (c) undertaking market studies to provide greater transparency to the market about existing good practice. For more on possible policy options, see Part C.2.3 of *A Legal Framework for Impact*.

E. Clarity about the need for coordination and collective action and use of finance operator alliances for finance flow measurement purposes

3.17 Traditionally, there may have been a tendency to approach legal duties on an 'individualistic' basis involving a detached assessment of costs and benefits by the operator that is subject to them. On that basis, if a finance operator cannot simply quantify a benefit it can realise by taking a given step at a cost that is individually acceptable, it might decide not to act.

3.18 However, climate threats for finance operators are system-wide, resulting from collective failures. Individual action, viewed in isolation, is unlikely to be effective in mitigating them. Solutions therefore almost inevitably also need to involve a collective, or at least coordinated, exercise.

3.19 The essence of a collective endeavour is that success can only be achieved collectively and those participating will only enjoy the fruits of success, at some level, collectively. Coordination increases the likelihood of success and the costs are spread, both potentially relevant considerations for a finance operator in deciding whether to pursue positive climate impacts in discharging legal duties.

3.20 Essentially, the position for finance operators in this area could be thought of as akin to an election. If one person does not participate, it may not make much difference (although it can), but if lots of people take that approach, the system will fail and everyone will suffer. Finance operators may be failing their shareholders, customers and beneficiaries if they do not 'take part'.

3.21 The collective initiatives under the GFANZ umbrella are intended to provide just this sort of coordination. The headline figures for assets represented by signatories are impressive. However, these initiatives remain a work in progress and not all finance operators are members. If they are to achieve their potential, it is therefore important that they continue to receive the focused attention of signatories so that they provide a context in which appropriate impact goals can be developed and effectively pursued – and seen to have been achieved.[9] Nonetheless, one way of seeking to assess how far finance is being effectively deployed in ways aligned with the Paris Pathway (and changes in the level of deployment) might be to understand the extent to which finance operators have signed up to and are actively engaged in initiatives of the sort contemplated by the GFANZ alliances. Even here, however, qualitative as well as quantitative assessments are also likely to be needed.

[9] 'Appropriate' in the sense that they need to align with the legal goals framework of finance operators.