Sharm el-Sheikh Dialogue

Inputs on the first workshop from AmbiciónCOP

AmbiciónCOP is an Ibero-American alliance that works at the Conferences of the Parties on climate to enhance climate action and promote Ibero-America in international climate initiatives. Therefore, our 3 objectives are 1-Encourage more ambitious climate action during COPs. 2-Encourage climate action and promote transparency during and among THE COPs with the monitoring of the implementation of the initiatives.3-Strengthen the inclusion of Ibero-America in the COP both as an agent of change and a driver of innovation as a beneficiary of the initiatives. To this end, we work on international climate action with a representation of the voices and initiatives of the Hispanic community, promoting dialogues, collaborations with actors from outside the region that share similar challenges and/or initiatives.

In the context of the Sharm-El-Sheikh Dialogue dialogue on Article 2, paragraph 1(c), of the Paris Agreement and its complementarity with Article 9 of the Paris Agreement, we would like to submit some inputs that we consider relevant to ensure finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.

First of all, we want to remind the importance of cooperation and equity in unlocking finance flows. We must provide green and just finance between and within countries working on being inclusive to all actors, even the smaller. Thinking about a green transition in the financial sector implies a dynamic of cooperation of financial actors, public, private and citizens to change the gaze towards a long-term approach, to create financial and technical incentives, and coherent and accessible mechanisms towards sustainability. In this sense we acknowledge the "1% for 1.5C" proposal of Mahmoud Mohieldin to address the current inequality of poorer nations paying both the highest human cost of climate change as well as the capital to shield themselves from it.

As this Dialogue offers to consider many challenges, actors and possibilities. If we are talking about making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development, we have to urge on stopping with financing fossil fuels, extractivism and deforestation. We need a reorientation of finance towards adaptation and mitigation projects, small actors empowerment and the conversion of polluting industries. However, the challenge is not so much the what as the how. To answer this question, from AmbiciónCOP we will highlight three specific key thematics to raise finance. First of all, we want to tackle **transparency** as a requirement for finance flows. Then, we want to raise awareness on **climate risk management** in banking systems. And last but not least, we will share our reflections on the necessity of aligned **green taxonomies**.

I. Transparency

Financial transparency is a key and topical issue, responding to a demand for access to information and the demand for accountability. It has to do with the notion of financial, social and environmental impacts. In the context of the fight against climate change, it ensures that we are moving in line with the Paris Agreements and towards Goal 1.5. Transparency of information on climate finance is important for the accountability of both public and private institutions, including financial institutions.

From AmbiciónCOP we identify **2 specific challenges** on which we have based our recommendations:

- The need to go further in transparency.
- The obligation of standardization and coherence in the deepening of transparency.

First challenge: The need to go further in transparency.

Transparency has become of prime importance, especially in the context of the Global Stocktake, so we have an easier access to information than before, but there are still challenges to tackle. Virtually all financial institutions have integrated principles of transparency, especially after the 2007 crisis. Today there are many regulations that affect transparency but it is still necessary to achieve new scopes especially in particular sectors or regions. The ECB's assessment of the progress made by European banks in disclosing climate and environmental risks, published in March 2022, covered 109 directly supervised banks and focused mainly on information at the highest level of consolidation. Compared to 2020, there are more banks disclosing significant information about climate and environmental risks. Nevertheless, in Latin America the percentage and level of disclosure is still low.

The current situation still calls for more transparency. Information remains dispersed, **convergence is needed to deliver comparable, consistent and coherent information**. The amount of information creates difficulties. Transparency requires **available, reliable and verifiable information, which entails the issue of traceability**. It is a key challenge to ensure credibility and trust in banking and financial system actors, especially in terms of environmental challenges. Hence, the challenge is to ensure that transparency is not only punctual but that it is in all the actions of the finance flows. To do so, a comprehensive transparency is needed that is institutional, about operations, that is linked to institutional responsibility and accountability.

To ensure a pathway towards low greenhouse gas emissions and climate-resilient development, **transparency must also take into account the integral impact**, that is, the environmental impact as well as the social one with the technical capabilities to take into account and manage the profusion of information that is delivered, to compare it, especially because of the differences between the models and mechanisms used.

<u>Second challenge: The obligation of standardization and coherence in the deepening of transparency.</u>

The second challenge identified focuses on the need for homogenization of transparency. In parallel to this, transparency has been so key that it developed very rapidly in all countries, for example with national roadmaps that include a component on data systems at the micro, meso and macro scales.

There are many challenges to this issue. There are currently many heterogeneous initiatives that could lead to fragmentation and an excessive burden in terms of ESG reporting. **Reporting mechanisms must be aligned globally** in such a way that it is easy to report, find information and processes. Transparency mechanisms involve **technical and financial capacities** for actors who do not have many resources. Even if regulations, norms and standards are accelerated, the construction of harmonized guides between countries cannot be forgotten. Social aspects are key to going further in providing just finance.

The ideal outcome should be the construction of an **international ESG sustainability standard** that is directly applicable in all jurisdictions. In the shorter term, close coordination between outreach approaches and international standards is needed to ensure interoperability. For example, European regulation continues to advance faster than in other geographies. It affects foreign banks operating in the EU and European banks operating in third countries. Europe is running more than the rest of the countries, with the risk of being disharmonized. Some progress has been made in terms of international cooperation, although further progress is needed. Perhaps focusing on the effectiveness of existing mechanisms and the harmonization of the transparency ecosystem is the priority.

Based on these challenges and the needs of financial transparency, we elaborate the following recommendations:

- To ensure **institutional transparency** in operations that carries institutional responsibility and accountability for operations.
- To ensure **trust and credibility** to move all sectors towards the just transition.
- To work at the same time on the **availability, reliability, comparability and traceability** of information.
- To establish an **international sustainability standard** that is interoperable in all jurisdictions with a standardized and accessible reporting process, available and centralized information and training dynamics for all actors.

II. Climate Risk Management

Risks are a crucial issue for the finance sector that created systems to contain these credit, interest rate, liquidity, financing and exchange rate risks. However, with the intensification of climate change, new risks appear with their consequences on the markets. Hence, the need to act to at least manage vulnerability and exposure to the danger caused by a climate risk. Managing these unprecedented risks in a system that was not designed to consider them comes with challenges. This is even truer in Latin America, which experiences the impacts of climate change very intensely, although it is not responsible for most of the emissions, and which, in fact, is in a situation of great vulnerability.

On this problem, we see 2 challenges:

1. The **consideration and integration of climate risks** in finance sector management.
2. Adjusting financial systems and markets to **reduce risks and support people** already suffering the consequences of climate change.

First challenge: consideration and integration by banks of climate risks in their management.

Having all the information about climate risks is crucial to design effective systems. They can carry significant risks to the financial stability of the entire system through common exposures and portfolio correlations. In addition, indirect effects on markets, as well as spillover effects on the real economy, can further aggravate the impact of climate risks beyond direct exposures from institutions. They become classic financial risks that take the form of excessive credit and leverage growth, illiquidity, concentrations of direct and indirect exposure, and misalignment of incentives. Therefore, there is a challenge to **reconcile climate risks, and to take into account their interactions with each other**. The figures show that banks are still going through a learning process. 60% of banks in the European Union do not have climate risks designed in their management system. Similarly, in Latin America, among 77 banks, only 15% manage climate risks and incorporate it as credit risk. The process of integrating systemic risks is very early, and we are still at the stage of understanding the risks and incorporating them.

There is a lack of data and capabilities to process and incorporate this information into the financial sector. Even if the **Task Force on Climate-Related Financial Reporting** works on these challenges by developing recommendations, it is crucial to encourage the **improvement of financial system information on climate risks**, both physical and transitional. It is also essential to **design evaluation models** that make visible the risks both in the short and long term and show the existing volatility.

<u>Second challenge: adjusting financial systems and markets to reduce risks and support people already suffering the consequences of climate change.</u>

With mitigation measures, we can reduce climate risks in the long term, but we are already living the consequences of climate change. These climate risks cannot be reduced, it is only necessary to adapt with a short-term management of vulnerability and exposure to the risks they generate. Ultimately, if nothing is done, they will become loss and damages that also require finance. Still today finance flows are not complete and on par with the existing challenges, but it must be recognized how positive an issue considered as so important at the international level is. The novelty of these risks requires other scenarios of analysis and action.

It raises the question of the actions and incentives of financial systems. The financial sector is seen as an intermediary in allocating resources to achieve a low-carbon economy. Thus, at the EU level, 2/3 of the income still comes from emission-intensive sectors and in Latin America, among 77 banks only 36% finance something they call adaptation, although in some cases there are already credit banks that assume emergencies related to climate impacts - such as drought - although they do not call it financing towards adaptation. For this, it is true that we have to completely change the matrix, **leave the BAU model, assume**

short-term economic losses to invest and evaluate in initiatives that have long-term value. However, it entails many uncertainties from the point of view of economics and to reduce them **a favorable regulatory framework is needed**. The lack of public policies weakens the transition to a new model of society.

Based on these challenges and the possibilities in terms of systemic risk management systems, we elaborate the following recommendations:

- The short-term climate effects and uncertainties need to be integrated into finance systems through a **microprudential and macroprudential approach** to safeguard financial stability.
- We must **leave the Business As Usual model** and accompany the actors who propose another system.
- **New formulas for the analysis of climate risks**, in addition to those exclusively financial, must be created to act in a complex and very changing scenario.
- It is key to **implement the TCFD** to offer standards in terms of responsibility, training, human resources, and customer requirements.
- **ESG standards**, anchored in national realities, can be built on to organise the market in terms of existing risks and opportunities.
- It is key to develop a **consensual definition of adaptation** to give a framework to the actions that already exist and encourage new ones.
- The financial sector must further **include adaptation financing** as a response to risks.
- It is key to enter **the training (technical, knowledge) of financial actors** to integrate climate risks into their management and see the opportunities.

III. Green taxonomies

Green taxonomies are still at an early stage of conception and implementation. They are not yet perfect, but it should be recognised that it is a good thing that this is an issue that is considered so important at the international level. They need efforts from all stakeholders to progressively reduce imperfections, however, as the latest IPCC report showed, we need to act now. Thus, we can say that in terms of green taxonomies the priority is **to achieve a transition in the production model and the financial system first**, and then work on the necessary improvements.

Green taxonomies exist to rethink sustainable activities, a very difficult task to take on, especially in the industrial sector and especially for actors who are not primarily experts. Once conceptualised, taxonomies need **an adequate framework and mechanisms** in place to support them in order to function. Thus, they **require a lot of capacity** on the part of the actors involved, mainly banking institutions. They also allow the introduction of a **just carbon price.** But, when there are several different taxonomies, the question arises as to how **to standardise them** in order to allow comparison and exchanges between these systems. The challenge is interoperability and its further work at international level.

Green taxonomies unveil 3 challenges:

1. The **definition of sustainable activities** to ensure a just and green finance.
2. The **empowerment of smaller actors** to have an easier access to finance.
3. The **interoperability of green taxonomies** to ensure international cooperation.

<u>The first challenge identified is the definition of sustainable activities.</u>

This process carries the risk of a bad approach leading to greenwashing, of instability of the system creating legal uncertainty and thus spreading discredit the overall system of green taxonomy. Taxonomies cannot be politicised, linked to the instability of governmental decisions and the agenda of political parties. We need taxonomies that **agree on sustainability criteria and on verification and reporting processes**. It involves a huge amount of data that must be acknowledged, interpreted and integrated in each area.

The second challenge relates to taxonomies as a new system in the financial sector, which implies certain capacities for stakeholders.

Green taxonomies should **ease up the access to finance**, especially for the third sector. Nevertheless, the challenge laying in that is quite tremendous. For instance, in January 2022, in Spain alone there were 2,928,7062 companies, among which only 4,977 were large companies. The private sector is a powerful but very heterogeneous actor in terms of activity, economic and legal power and capabilities. In Latin America, 99% of SMEs are cooperatives and 55% of productive individuals are active in the informal economy. Thus, access to finance for these actors is a challenge that is not entirely solved by green taxonomies. **Bridging these tremendous gaps** is a challenge of green taxonomies that must ensure **equal access to information and requirements that take into account the real economy and the current conditions of SMEs and other small actors such as the third sector**. Green taxonomies cannot be effective without **considering situations of social vulnerability**, which requires banks to review their criteria, such as the need to demonstrate insolvency, in order to support projects and initiatives that fall outside the Business As Usual model.

Green taxonomies must serve the real economy. In this sense, they must reflect the society in which they stand out. Thus, other criteria emerge, such as biodiversity, governance and social, which highlight the fact that **taxonomies cannot only be green and mitigation-oriented**. In Latin America, there is a real need for adaptation finance, a sector that is not financially profitable. This challenge shows that the financial sector is not capable of implementing taxonomies. It calls for efforts from all stakeholders, including the public sector.

The final challenge concerns the interoperability of green taxonomies.

There are differences in capacities, systems, context and priorities at the international level that prevent perfect homogeneity. There are many differences between Latin America and the European Union, for example, the most demanding thresholds in the EU are impossible to require in Latin America, or the need to include land use in Latin America. In the same way, it is necessary to introduce a tax system to make a transition, but it is not possible to imagine a global tax, disconnected from national realities. However, in globalised economies, it is not possible to think of financial systems that are totally disconnected and incompatible. There is a crucial need to **generate consensus**, a common framework on the principles of taxonomies, and the requirements. **Regional frameworks** are possible, although there is **room for manoeuvre for national specificities** when elaborating national green taxonomies. It is already a challenge that is being worked on at the Latin American level in a project that was launched in 2022 and will last 2 years. In this work, it appears that the EU is able to contribute in particular thanks to its lessons learned when implementing its own green taxonomy and also thanks to similarities with Mexico and Colombia.

Based on these challenges, challenges that limit the creation, implementation and functioning of green taxonomies, we elaborate recommendations to contribute to the collective efforts of reflection:

- Create green taxonomies with **simple and accessible standards** so that the system can be used by all stakeholders.
- Start with an imperfect system that responds to the urgency to make a transition and **keep improving it** to reach subsequent versions that are more in line with all the components of CSR.
- Proceed with caution on the taxonomy criteria, leaving a **margin of flexibility** to adapt to the contexts.
- Create a c**oherent framework of green taxonomies that respects national needs and particularities**. In the case of LATAM, use the EU case to develop an aligned regional framework, so as to coincide on priority sectors (agri-food, construction and tourism) and highlight the region's natural capital.

- Create green taxonomies that **consider the whole product cycle and value chain** to value products and projects that come out of the BAU model.
- **Separate green taxonomies from political agendas** to ensure stability of systems.
- **Include Adaptation** in the green taxonomies, especially in LATAM, with the support of the public sector to ensure the financing of these projects.
- Create taxonomies that are not only green, but that **integrate more criteria** such as the other components of CSR.
- Accompany green taxonomies with **capacity building measures** to address the challenges of all stakeholders in implementing and participating in these systems.