EUROPEAN CENTRAL BANK
EUROSYSTEM

Climate Change Centre

ECB-RESTRICTED

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COP26 key messaging on climate action from external stakeholders

This document was prepared as background information ahead of Mr Elderson's attendance at COP26

1. Effective and transparent carbon pricing

- **The true social and environmental cost of carbon should be incorporated into the prices paid by all sectors of the economy**, through higher carbon taxes or carbon allowance prices. Adequate carbon pricing is considered the most effective policy instrument to create incentives for the green transformation. **As long as environmental externalities are not adequately priced in, green investments can be expected to remain well below their desired level.**
- **Current carbon pricing efforts at the global level are not on track to meet Paris Agreement goals**. Notwithstanding large regional differences, carbon pricing schemes cover only about one fifth of global emissions, and carbon prices in the recommended range to meet Paris Agreement goals cover less than 5% of global emissions.[1]
- The cost of climate policies like carbon pricing to reduce emissions and make our economy greener would pose considerable transition risks, particularly for high-emitting industries and in the case of a disorderly transition. However, our economy-wide stress test shows that **while transition costs may be higher in the short-term, they are much lower in the long run than the catastrophic costs of unrestrained climate change.**
- In order to minimise the negative effects of carbon pricing on more vulnerable groups and to cater for a higher political acceptance of climate policies, **governments should use the additional revenue from higher carbon taxes to compensate citizens hit most** by the rising cost of fossil fuels and to **foster green investment in the residential building sector**.
- Nevertheless, **carbon pricing should not be viewed in isolation, but rather together with a wide set of tools to tackle climate change**. To be most effective, such tools must be embedded in an overall ambitious climate and environmental policy context that is conducive to a long-term green transformation of the economy. The proposal by the European Commission on the so-called "fit-for-55-package" seems to be very promising in this respect.

[1] World Bank, "Carbon Prices now Apply to Over a Fifth of Global Greenhouse Gases", 25 May 2021, available at: https://www.worldbank.org/en/news/press-release/2021/05/25/carbon-prices-now-apply-to-over-a-fifth-of-global-greenhouse-gases

2. Financing the transition

- **Greening our economy will require a transition by decoupling our economic activity from carbon emissions**. Significant advances have already been made in zero-carbon technological progress, yet many challenges remain, particularly with regards to carbon capture and storage as well as the greening of carbon-intensive sectors like cement, steel, and iron.
- This **technological innovation will require extensive funding**. Between $100 and $150 trillion will likely be required over the next three decades to invest in critical infrastructure and technology to meet net zero goals, and public investment in R&D for key low-carbon technologies will need to approximately triple from today's level[2].
- **Private finance will also be needed to bridge the funding gap to finance the transition**. Incentivising and accelerating innovation will involve the entire structure of the financial system, including transparent and comparable climate disclosures, improved climate risk management, and credible transition paths.

3. Global consistent and comparable climate disclosures

- **Disclosure of climate exposures should be complete, internationally consistent and auditable.** It will help markets to price more accurately and provide incentives to decarbonise, helping to fuel the transition to a greener economy and deter greenwashing. Climate-related disclosures need to follow standardised and commonly agreed definitions. While TCFD-based disclosures have underpinned public and private efforts to improve information-sharing, disclosures need to be at a far more granular level of detail than is currently available.
- Furthermore**, we need mandatory disclosures of climate-related risks from a far greater number of companies, as well as disclosures of forward-looking measures** that assess the extent to which firms are aligned with climate goals and net-zero commitments. At the same time, it is vital to ensure that the various disclosure initiatives currently underway are fully aligned and consistent with one another to ensure overall transparency as well as minimise to the extent possible the burden on reporting entities.
- **A further essential step is the consistent and transparent inclusion of climate risks in credit ratings**, where more work is still needed. For instance, the European Commission's intentions to explore initiatives to ensure that ESG risks are systematically captured in credit ratings is a welcome step in the right direction. [redacted].
- Moreover, while the number of ESG data providers is on the rise, **the comparability of ESG ratings remains limited**, also due to methodological differences. The European Commission's plan to strengthen the reliability and comparability of ESG ratings is a welcome step in the right direction.

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[2] Based on a range of estimates for 1.5C-aligned net zero scenarios from: International Energy Agency, "Net Zero by 2050: A Roadmap for the Global Energy Sector", May 2021, available at: https://www.iea.org/reports/net-zero-by-2050; Network for Greening the Financial System, "NGFS Climate Scenarios for central banks and supervisors", June 2021, available at: https://www.ngfs.net/sites/default/files/media/2021/08/27/ngfs_climate_scenarios_phase2_june2021.pdf;, International Renewable Energy Agency, "World Energy Transitions Outlook: 1.5C Pathway", June 2021, available at: https://www.irena.org/publications/2021/Jun/World-Energy-Transitions-Outlook; and BloombergNEF, "New Energy Outlook 2021", July 2021, available at: https://about.bnef.com/new-energy-outlook/.

- **Finally, ensuring the coherence of legislation and avoiding a further increase in its complexity will be crucial to ensure the success of sustainable finance**. The growing corpus of sustainable finance regulation arising from a decentralised approach to decision-making and the complex interactions between the various legislative pieces presents a challenging landscape of disclosure obligations to navigate and comply with.

4. Clear and timely transition paths

- **Banks should develop transition plans compatible with EU policies implementing the Paris Agreement that include concrete intermediate milestones from now until 2050, and disclose progress towards these goals on an annual basis. To support this effort, transition plans should become a legal requirement.**
- The results of our economy-wide climate stress test clearly show that **firms and banks clearly benefit from adopting green policies early on to foster the transition to a zero-carbon economy.** The advantages of taking early action outweigh the initial costs of introducing policies to reduce carbon emissions and the physical, irreversible risk of unaddressed climate change.
- **More credible, ambitious, and predictable government climate policies are needed to foster more green investment, faster decarbonisation, and to make our economies more resilient.** While the number of countries that have pledged to achieve net-zero emissions has grown rapidly over the past year and are consistent with a global warming of 2.1C[3], current nationally determined contributions (NDCs) would only limit temperature increases to 2.5C[4].
- Moreover, European banks must incorporate these structural changes in their strategic decision-making and steer their business strategy towards a smooth transition to carbon neutrality.
- Efforts in this regards are well underway: for instance, the Glasgow Financial Alliance for Net Zero (GFANZ), an initiative of the COP26 Private Finance Hub, brings together banks representing almost a quarter of global banking assets who are committed to aligning their business practices to net zero by 2050 along with annual progress reports.
- **The European Commission's sustainable finance strategy and its proposal for a Corporate Sustainability Reporting Directive (CSRD) are also important steps towards improving financial institution disclosures and transition plans**. Notably, the CSRD proposes mandatory disclosures of sustainability targets and transition planning for large and listed companies including SMEs, banks and other financial institutions, which will have to disclose plans to ensure that their business model and strategy are Paris-aligned and compatible with the transition to a sustainable economy. CSRD reporting includes an audit requirement.
- However, **the Commission's strategy is still under development and it remains to be seen whether clear milestones will be mandated for such transition plans**. Moreover, while most banks have stated carbon emission goals for 2050, they currently systematically fail to link them to their current and medium-term actions.
- As a result and to complement the Commission's proposal for a CSRD, a legally binding obligation should be introduced for banks to develop a detailed transition plan that highlights, from now until

[3] International Energy Agency, "Net Zero by 2050: A Roadmap for the Global Energy Sector", May 2021, available at: https://www.iea.org/reports/net-zero-by-2050

[4] Network for Greening the Financial System, "NGFS Climate Scenarios for central banks and supervisors", June 2021, available at: https://www.ngfs.net/sites/default/files/media/2021/08/27/ngfs_climate_scenarios_phase2_june2021.pdf

2050, the bank's alignment and potential divergences from Paris-aligned policy objectives, including clear intermediate milestones and corresponding performance indicators.

- This binding requirement would push banks to more thoroughly assess the structural changes that will likely occur within key industries and would allow competent authorities to understand and act upon risks arising from a misalignment with the transition path.

5. Enhanced climate risk management

- **Banks should adequately manage climate and environmental risk.** Currently, 90% of practices are deemed by banks themselves to be only partially or not at all compliant with the ECB's supervisory expectations of adopting a comprehensive, strategic and forward-looking approach to disclosing and managing climate-related environmental risks.
- **Banks should measure and monitor the alignment of their portfolios, including defining key indicators for climate and environmental risks, and considering how to make their business strategy Paris-aligned** while avoiding an excessive build-up of transition risks and at the same time effectively financing the green transition of the corporate sector. Such forward-looking analyses should be an elementary practice in managing climate risks and embedded into banks' business strategy.
- Moreover, **existing prudential frameworks** such as the Basel Framework **must be updated to better reflect climate risks** with forward-looking quantitative assessment methodologies, including sufficiently granular data and long enough time horizons for risks to manifest.

6. Improved adaptation to climate change

- Even in the best possible scenario where we limit global warming to the goals of the Paris Agreement, the physical risks to our economy will still increase. While we must make every effort to contain those risks as much as possible, we should also **pay close attention to adapting to our changing climate and making our economies resilient.**
- [redacted]
- Insurance companies also have a key role to play in climate risk management. Research shows that economic activity is less affected by climate catastrophes when a greater share of damages is covered by insurance.[5] Yet in Europe, only 7% of climate-related catastrophes are insured.
- As such events become more frequent due to climate change, insurance protection and risk-pooling are becoming ever more important and require further consideration at national and European levels to ensure that our economy is adequately protected.

7. Green bonds

- **A clear and reliable, harmonised public framework for green bonds will be key to enable investors to identify environmentally sustainable investments based on transparent,**

[5] Fache Rousová, L. et al., "Climate change, catastrophes and the macroeconomic benefits of insurance", Financial Stability Report, European Insurance and Occupational Pensions Authority, July 2021, available at: https://www.eiopa.europa.eu/document-library/thematic-article/climate-change-catastrophes-and-macroeconomic-benefits-of_en

comparable, and reliable data; to combat greenwashing, and to channel funds to fill the sustainable investment gap for the green transition. Current green bond labels rely on definitions that are not sufficiently standardised, rigorous, or comprehensive, thereby undermining the credibility of the green bond market due to greenwashing concerns, dampening demand for green bonds, and possibly hindering the green bond market's capacity to foster the transition to a greener economy.

- The proposal for a regulation of the European Parliament and of the Council on European green bonds is a significant step in developing the market for high quality green bonds while minimising disruption to existing green bond markets and reducing the risk of greenwashing.
- However, under the proposed regulation, the use of the European green bond standard would be voluntary. While this approach is appropriate for the short-term to avoid possible sudden divestment and a drop in green bond issuance, a clear commitment to making the European green bond standard mandatory for newly issued green bonds within a reasonable time period will be necessary to achieve a green bond market that is consistent with the EU's taxonomy and to mitigate greenwashing concerns,
- Moreover, it will be important that the European green bond standard avoids diverting issuers towards jurisdictions with less rigorous requirements, which could eventually lower the environmental standards of sustainable finance products at a global level.
- To this end, **effective international cooperation**, notably in the context of the G20 Sustainable Finance Working Group and the International Platform on Sustainable Finance, will be **essential to ensuring the international coherence of standards for green bonds.**