XPS Investment

# Investment briefing

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# COP27 culminates in new agreement to help poorest nations deal with effects of climate change

## In brief

- Delegates from countries across the world met in Sharm el-Sheik, Egypt at COP27.
- A landmark agreement around "loss and damage" funding to provide compensation to developing nations.
- There was no strengthening of the COP26 agreement to 'phase down' coal – it was hoped this would be extended to other fossil fuels.
- The UN Secretary-General described the outcomes as 'clearly not enough' owing to the fact there was little progress on policies to cut actual emissions, with the focus instead on adapting to the increasingly likely effects of climate change.
- Pension schemes must continue to consider the long-term implications of climate change on their investment strategy and be proactive as new investment opportunities arise.

COP27 ended on Sunday 20th November, two days later than scheduled, as delegates from around the world pushed to finalise a deal on "loss and damage" funding, which for the first time formally recognises the need for developed nations to compensate developing nations for the effects of climate change.

In this note Matt Jarvis discusses this and other key outcomes from the Conference and the implications for pension schemes.

## Background and context for COP27

The UN Conference of Parties meet every year to accelerate action towards the goals of the Paris Agreement. This year COP27 took place in Sharm el-Sheik, Egypt, with the intention of building on the pledges put forward at COP26 (you can read more on COP26 **here**).

The UN's latest report on global emissions released in October 2022 provided a bleak picture for context – current policies would lead to warming of 2.8°C above pre-industrial times by 2100 and the UN declared there has been "inadequate action to date" to meet Paris Agreement goals. With global temperatures already 1.1°C above pre-industrial times, the UN affirm there must be a 45% cut in emissions by 2030, and "a rapid transformation of societies" is required to limit warming to 1.5°C, a key pledge of the 2015 Paris Agreement.

**The annual conferences continue to put climate change on the agenda and pension schemes must consider the implications of the outcomes and commitments on their investments.**

**Matt Jarvis**
Senior Associate

## What were the key outcomes and commitments?

We set out below the key outcomes from the discussions and implications for pension schemes.

### A breakthrough for loss and damage

Loss and damage, an idea first touted in 1991 by Vanuatu, a South Pacific Ocean nation, was a notable omission from COP26 but it was high on the priority list for developing nations this year. After initial disagreements on how (if at all) it should be discussed, a breakthrough agreement was finally reached on the final day of the meeting.

The agreement aims to establish new funding arrangements for assisting developing countries that are particularly vulnerable to the adverse effects of climate change and to establish a fund for responding to loss and damage. No money has yet been committed to the fund, although separate pledges were made which amount to c.$250m. A 'Transitional Committee' will be formed over the coming months consisting of 10 members from developed nations and 14 from developing nations who are responsible for providing recommendations on the mechanism for contributing and distributing money to be tabled at COP28 in November 2023.

A key discussion point was which nations should be classified as 'developed' or 'developing'. The EU argued that China should be classified as developed, and hence should be making payments to developing nations, given China is the world's largest emitter.

### Lack of strengthening of commitments to reduce carbon emissions

There was no strengthening of the COP26 agreement to 'phase down' coal. Whilst 80 nations called for the COP26 ambition to phase down coal to be expanded to include other fossil fuels, no agreement was reached. Instead, there was inclusion of wording allowing a transition to "low-emission" sources, which is potentially a loophole for natural gas to continue to be used. Attempts to have nations agree to peak global emissions by 2025 also fell flat.

COP26 saw nations agree to "revisit and strengthen" their emission reduction targets ahead of COP27 but very few nations have done so.

There was a marked increase in the number of delegates from fossil fuel companies in attendance. The United Arab Emirates sent more delegates from fossil-fuel companies than any other nation and is set to host COP28.

**A key theme from COP27 was greater focus on providing finance and support to developing nations in managing the consequences of climate change.**

## Progress on Mitigation and Adaptation finance

New pledges totalling more than $230m were committed to an "Adaptation Fund" to help vulnerable communities around the world adapt to climate change. A report has been requested by the UN Framework Convention on Climate Change (UNFCCC) on doubling adaptation finance for consideration at COP28.

This comes off the back of concern that in 2020 finance flows towards mitigation and adaptation fell $17bn short of the annual $100bn global goal pledged in 2009 by developed countries. The UN's latest Adaptation Gap Report estimates that adapting to the climate crisis could cost developing countries up to $340bn annually by 2030. Adaptation covers activities such as building sea walls and creating drought-resistant crops.

Rishi Sunak announced the UK would triple its funding for adaptation solutions from £0.5bn in 2019 to £1.5bn by 2025, making good on a COP26 request to double 2019 financing by 2025. The EU announced an additional €1bn of funding for adaptation initiatives in Africa. Outside of COP27, at the G20 summit in Bali it was announced that Indonesia had secured $20bn in financing from the G7 to speed up its transition from fossil fuels to renewable energy.

## More countries commit to reducing methane

Another 50 nations joined the 100 which committed to the Global Methane Pledge at COP26. The pledge aims to reduce global methane emissions by at least 30% from 2020 levels by 2030. China, Russia and India, the world's first, third and fourth largest methane emitters did not commit to the pledge, but China raised hopes of a future commitment as they confirmed a draft methane reduction strategy was being established.

## Weaker rules on carbon credits

At COP26, countries agreed to create the rules that would allow nations to trade carbon credits, under an agreement known as Article 6. At COP27, a more detailed framework was discussed for trading of carbon credits, including allowing corporations to buy credits from governments. The US launched a new voluntary carbon trading market with the aim of boosting private investment in clean energy projects in developing countries.

Critics of carbon credits argued the rules are not strict enough and risk a proliferation of poor-quality carbon credits which act as a barrier to actual reduction of carbon emissions.

## Biodiversity and forestry on the agenda

Day 10 was themed 'Biodiversity Day' with the intention of giving focus to biodiversity, given its importance in mitigating the worst effects of climate change. A new partnership was announced called 'Enhancing Nature-based Solutions for an Accelerated Climate Transformation' (ENACT), which has a wide-ranging remit and seeks to coordinate global efforts.

The Forest and Climate Leaders' Partnership (FCLP) was launched, aiming to promote action to implement the commitment to halt forest loss and land degradation by 2030. Brazil's newly elected President Luiz Inacio Lula da Silva, vowed to re-engage the nation on climate change and end deforestation by 2030.

## What comes next and what does it mean for pension schemes?

- Trustees have a fiduciary duty to act in the interests of members and it's clear that considering the impact of and solutions to climate change is aligned to members' long-term financial interests. It is therefore vital that pension schemes ensure their investment managers are considering the physical and transition risks and opportunities associated with climate change.
- For pension schemes, the recommendations made by the Transitional Committee in relation to loss and damage will be important in determining how financial resources will be mobilised and utilised. There is reference to the World Bank and the IMF contributing to funding arrangements, providing support for investments in solutions for climate change – new investment opportunities will arise as countries and businesses respond.
- Annual investment in clean energy needs to triple to more than $4tn (£3.5tn) by 2030, according to the International Energy Agency. Carbon credit markets which are larger and more standardised will create opportunities for pension schemes to earn revenue from investing in activities which create credits, such as forestry or renewable energy.
- COP27 highlighted increasingly divergent views as to which fossil fuels should be phased out and at what speed. Ahead of COP27, hosts Egypt and several other nations promoted natural gas as "the perfection solution" to both the climate crisis and energy security. Pension schemes should discuss and agree their beliefs around investing in fossil fuels considering the long-term risk and return aspects in a highly debated sector.
- The annual COP meetings and pressure on governments to meet commitments are likely to prompt further regulation on pension schemes and companies they invest in, providing tailwinds for sustainable megatrends. Climate change reporting regulation already affects large pension schemes, and the recent FCA consultation on Sustainable Disclosure Requirements (SDR) is a pertinent development which pension schemes will need to be mindful of when selecting funds to invest in. You can read more on the SDR **here**.

## Next steps for pension scheme trustees

**Trustees need to be actively considering these issues. XPS can help to provide support to schemes in the following areas:**

1. **Undertake training on areas of growing importance** such as setting a Net Zero pathway and addressing biodiversity.
2. **Use our Responsible Investment Framework** to establish your Scheme's desired approach and identify areas to be enhanced.
3. **Review your current investment managers** against your policy and **engage** to improve outcomes.
4. **Switch your investments into sustainable funds** which may have a specific Net Zero or Paris Alignment objective, or seek to contribute to broader UN Sustainable Development Goals, including targeting positive social outcomes alongside the climate transition.

## For further information, please get in touch with Alex Quant or Matt Jarvis.


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## Alternatively, please speak to your usual XPS Investment contact.


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