The Climate Crisis, Sustainable Finance & “Made in Canada” solutions:

Further incrementalism or authentic leadership?

Discussion Note
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Executive Summary

The world has been struggling to come to terms with climate risk for several decades but as a result of procrastination, the risk is now systemic if not existential in nature, and also coincides with growing economic inequality and populist threats to democracy in many countries. Had Canada and other countries acted in the 1970's when warnings were first made, incremental low cost solutions may have worked. That opportunity has been wasted and now the choice is much more stark.

As a prosperous nation with a climate aware public, Canada has a unique opportunity to demonstrate what authentic financial sector resilience looks like in the face of climate risk. This Preventable Surprises Discussion Note considers if the current preoccupation with "Made in Canada" solutions to global challenges will become yet another excuse for incrementalism, reflecting a political and financial system still under the thumb of fossil fuel lobbyists. Or whether it can be a springboard for Canada to finally step out from behind the American shadow to show the leadership befitting one of the world's most sophisticated and otherwise well governed financial systems. This comment builds on earlier papers in **October 2015**[1] and **September 2018**,[2] and encourages the Expert Panel on Sustainable Finance to seize the opportunity for authentic leadership in transitioning the financial system away from fossil fuels.

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Acknowledgements

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[1] 'Canada: an opportunity for investor leadership on climate change:' https://preventablesurprises.com/wp-content/uploads/2015/10/Canada-chapter_October2015.pdf

[2] 'Sustainable Finance in Canada: time for authentic leadership:' https://preventablesurprises.com/wp-content/uploads/2018/09/Sustainable-Finance-in-Canada-PS-Discussion-Note-17.09.2018.pdf

A tale of two Expert Groups: Canada's sustainable finance leadership opportunity

With Canada's Expert Panel on Sustainable Finance expected to publish its final report shortly, this note compares the Canadian approach to the global climate crisis with the European response. Similar to the Canadian Expert Panel, work at the European Sustainable Finance Expert Group takes guidance from existing legislation, policies and goals. Both expert groups are anchored in the legal obligations committed to in the Paris Agreement. This means limiting global temperature increase to well below 2 degrees Celsius, while pursuing efforts to limit the increase to 1.5 degrees Celsius, and aligning financial flows with these same targets.[3] Canada, EU member states and other signatories to the Paris Agreement understand that meeting the goals will require the phase out of fossil fuels in the global energy system in order to bring greenhouse gas emissions down to net zero by mid-century at the latest.

The financial sector needs clarity on the end goal and timeline for an energy transition aligned with the Paris Agreement, and the Canadian Expert Panel should provide this. At present, ome stakeholders describe a planned decline in the mix of fossil fuels in the global energy system and significant GHG reductions resulting in a 'low carbon' global economy as compared to the goal of a rapid decarbonization of the global energy system to net zero GHG emissions by 2050. An energy system transition to a low carbon economy should not be confused with rapid decarbonization to an economy with net zero GHG emissions. This includes Canada's current GHG emissions reduction commitment to transition to an 80 % reduction in emissions relative to a 2005 baseline and from 704 Mt CO2 equivalent per year in 2016 to 148 Mt CO2 equivalent per year by 2050. This GHG reduction plan is part of the Pan-Canadian Framework for climate change outlined in Appendix III of the Canada Expert Panel interim report on Sustainable Finance.[4] This is not a commitment by Canada to net zero GHG emissions by 2050. There is a need to further increase the ambition level to reach net zero emissions and closely align with both the climate science and commitments from other jurisdictions leading on climate change action. The Canadian Expert Panel's work and action by the financial services sector will be critical in supporting this necessary higher level of ambition.

The Canadian financial system is global, and the Expert Panel's work should reflect this

Canada's international financial assets are around $5 trillion, with around $3 trillion of this sitting in public equity markets outside of Canada, primarily in the US.[5] Approximately $1.2 trillion are invested in fixed income instruments and $350 billion sits in currency and deposits. Private direct investments in agricultural land and infrastructure, as well as various classes of alternative debt securities around the world make up the rest.[6]

Much of the financial systems assets are held in the pension system, which is made up of large globally diversified investors. Alongside pension funds, the insurance sector and commercial

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[3] UNFCCC 'The Paris Agreement:' https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

[4] 'Expert panel on sustainable finance interim report:' https://www.canada.ca/en/environment-climate-change/services/climate-change/expert-panel-sustainable-finance.html

[5] Statistics Canada (2019) 'Canada's international investment position, fourth quarter 2018:' https://www150.statcan.gc.ca/n1/daily-quotidien/190313/dq190313a-eng.htm

[6] Inderst G. (2013) 'Pension Fund Investment in Infrastructure: A Comparison between Australia and Canada,' OECD Working Papers on Finance, Insurance and Private Pensions: http://www.oecd.org/pensions/pensionfundinfrastructureaustraliacanada2013.pdf

banks are the other key pillars of the financial system who have yet to respond to climate and associated sustainability risks in a uniformly prudent manner. The financial system is highly concentrated across major players in the insurance, pensions,[7] and banking sectors, with the six federally-regulated banks holding over 90 percent of bank assets. This concentration means that leaders in each of the respective sectors could play a significant role in driving real change across the capital markets in line with climate targets.

Foreign investors hold around $4 trillion in Canadian equities and debt securities and a significant portion of this is held by European investors.[8] European Union member states account for around $40 trillion in household financial assets making them an important ally in the decades ahead.[9] If one includes the UK financial system[10] with over $25 trillion in household financial assets, and a large domestic payment and settlement system processing over $300 trillion annually - the benefits of alignment are even more clear. The UK financial sector has communicated a desire to remain in the leadership group on sustainability and climate action,[11] regardless of what happens with Brexit. Should Labour become the governing political party in the UK, and especially if it needs to rely on Liberal Democrat and Green Party parliamentarians, there are indications that it will move forcefully in this direction as part of a UK Green New Deal, which could include delisting climate laggards from the London Stock Exchange.[12] The EU and China are also collaborating closely on sustainable finance strategies. The Expert Panel's work should reflect the globalised nature of the Canadian financial system and the international nature of climate change impacts and associated emissions reductions targets.

Canada needs to align itself with the leaders, not the laggards

Members of the European Expert Group are working on a taxonomy as a new "metric system" for transitioning the world's financial system away from fossil fuels and associated high emissions activities. The group defines thresholds for the eligibility of economic activities according to metrics such as absolute GHG emissions (C02 equivalent Mt) and carbon intensity (gCO2/kWh) based on the best available science. A global metric system suitable for a successful transition away from fossil fuels must track total emissions from individual sources and regions to be useful, otherwise, it is highly likely that total emissions will continue to rise. Canada should ensure that

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7 Pension funds have gross assets under management of over $1.5 trillion, accounting for about 15 percent of total assets in the Canadian financial system. See IMF (2014) 'Canada - Financial sector stability assessment': https://www.imf.org/external/pubs/ft/scr/2014/cr1429.pdf

8 Statistics Canada (2017) 'Canada's international investment position, third quarter 2017:' https://www150.statcan.gc.ca/n1/daily-quotidien/171213/dq171213a-eng.htm

9 Eurostat (2019) 'Households - statistics on financial assets and liabilities:' https://ec.europa.eu/eurostat/statistics-explained/index.php/Households_-_statistics_on_financial_assets_and_liabilities#Value_of_assets_and_liabilities

10 The 'financial system', in this context, refers to the sum of all the financial assets owned by banks and non-bank financial companies in the United Kingdom. See Bank of England (2015) 'Mapping the UK financial system:' https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2015/mapping-the-uk-financial-system.pdf

11 City of London Green Finance Initiative Working Group on Data, Disclosure and Risk (2018) 'Establishing the world's best framework for climate-related and sustainability-related financial disclosures:' www.greenfinanceinitiative.org/wp-content/uploads/2018/04/Data-Risk-and-Disclosure-Paper.pdf

12 FT (10.05.2019) 'UK Labour plan to delist companies to force action on climate change:' https://www.ft.com/content/f47e2bc2-733b-11e9-bbfb-5c68069fbd15

its plan to reduce total emissions to net zero aligns with global science-based targets to do the same. This science is the work of UNFCCC scientists, such as the 'Emission Pathways and System Transitions Consistent with 1.5°C Global Warming', among other documents.[13]

Metrics and targets are required to manage the systemic wind-down of the fossil fuel sector

Investors, boards of directors and management teams should not be confused with selective disclosures of metrics and targets by investee companies, governments, and asset managers which identify a reduction in GHG or carbon intensity when at the same time absolute GHG emissions are increasing. This is the case in current disclosures from some companies in the energy, utility, transportation and mining sectors. In many cases, disclosures indicating alignment to climate risk mitigation and Paris Agreement targets are misrepresenting the emissions trajectory and capital expenditure allocation plans of the companies in question. In order to address this misalignment and tendency to misrepresent emissions reductions targets, the Canadian Expert Panel and those who implement its recommendations should be referring to the same body of internationally peer-reviewed research and publish credible plans to align the Canadian financial system with these metrics and targets. The Canadian investment community, financial regulators and policymakers should be referring to the same science-based emissions targets as their international peers.

According to Helena Viñes Fiestas, Deputy Global Head of Sustainability at BNP Paribas Asset Management and a member of the European Commission's Technical Expert Group on Sustainable Finance, the European Commission's taxonomy "will enable the measurement of private and public, national and international capital flows to environmental activities within and beyond Europe. A standardised, science and evidence-based taxonomy will dissipate widespread fears of greenwashing and, more importantly, it will foster investments where they are most needed."[14]

Canada now has a strategic decision to make

Canada has a strategic choice – it could align its work on a sustainable finance taxonomy with European efforts or it could try to create its own system and align with laggard nations like Australia and Saudi Arabia. Current indications are that Canada may seek to do the latter. According to Tiff Macklem, Dean of the University of Toronto and Chair of the expert panel, "The Europeans want their taxonomy to be an international standard, and they are ahead of us. But it's

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[13] UNFCCC (2018) 'Emission Pathways and System Transitions Consistent with 1.5°C Global Warming:' https://unfccc.int/node/185521

[14] BNP Paribas (2019) 'The EU taxonomy: the metric system of the 21st century:' https://institutional.bnpparibas-am.com/eu-taxonomy-metric-system-21st-century/#acceptLicense; https://ec.europa.eu/info/publications/sustainable-finance-technical-expert-group_en. The European Commission taxonomy will be based on the Nomenclature statistique des activités économiques dans la Communauté européenne (NACE) codes, the European industry standard classification system. The Canadian equivalent is the North American Industry Classification System (NAICS). The NACE and NIACS systems have equivalent sectors. See 'Correspondence table between the Statistical Classification of Economic Activities in the European Community, Rev. 2 (NACE Rev. 2) and the North American Industry Classification System, 2017 (NAICS 2017)': https://ec.europa.eu/eurostat/ramon/relations/index.cfm

important for us to look for a taxonomy that represents our country..."[15] But a 'Made in a Canada' approach when applied to a globally diversified financial system makes little sense.

'Made in Canada' leadership could be authentic and globally significant

The 'Made in Canada' approach currently favoured by the Expert Panel could make a clean break with the fossil fuel sector dogma and the political capture which has defined Canadian climate action to date. Instead, the Expert Panel could push for authentic leadership that:

(a) Makes full use of Canada's diplomatic as well as its financial influence via the global exposure and reputation of the Big 8 pension funds, alongside insurance and banking sector leaders. This is required to ensure global corporate change, even if elements of the federal government and respective provincial governments are not supportive of substantive climate action; and

(b) Involves Canada playing catch up with its global peers so that it rejoins the leadership group. This means acknowledging that an energy transition along a 'low carbon pathway' is good rhetoric but not enough, and instead commit to a transformation pathway of rapid decarbonisation to a net zero emissions economy by mid-century.

Central bankers and regulators are creating the future financial system architecture and Canada must be at the heart of it

The Bank of Canada's recent Financial System Review indicates that climate change is now on the financial regulatory agenda and this is welcome. The Review notes that "asset prices may not fully reflect carbon-related risk," and notes concern that "rapid repricing [of high-carbon assets] might cause fire sales and interact with other vulnerabilities - like excessive leverage-destabilizing the financial system.[16] The central bankers who will lead the global financial system's transition away from fossil fuels have come together as the Network for Greening the Financial System (NGFS).

The Bank of Canada and the Office of the Superintendent for Financial Institutions' participation as observers at the most recent Paris NGFS meeting in April is a welcome development. But passively observing a global energy transition is not the same as sharing in the leadership responsibilities and benefits.[17] The Canadian Expert Panel should review the NGFS work and make strong recommendations for Canada's central bank and its prudential regulator to respond

[15] 'Canada's 'HLEG' considers alternative green taxonomy for resource-heavy economies' (26.05.2019): https://www.responsible-investor.com/home/article/canadas_hleg_taxo/

[16] Bank of Canada (2019) 'Release of the Financial System Review:' https://www.bankofcanada.ca/2019/05/opening-statement-160519/

[17] The group is focused on enhancing (i) climate and environment-related risk management for supervisory authorities and financial institutions, (ii) scenario-based climate risk analysis and (iii) incorporating sustainability criteria into central banks' portfolio management. See Banque de France (2019) 'NGFS calls for action by central banks, supervisors and all relevant stakeholders for greening the financial system:' https://www.banque-france.fr/en/communique-de-presse/ngfs-calls-action-central-banks-supervisors-and-all-relevant-stakeholders-greening-financial-system

proactively to the three work streams that are well underway.[18] In particular, the Expert Panel should engage Canadian stakeholder in with the global central banking dialogue on reducing systemic climate risk by introducing a 'penalising factor' for projects incompatible with a climate secure future – higher capital requirements for bank lending to carbon-intensive assets. As other central banks lead on the decarbonisation of their respective economies, Canada needs to ensure it is not left behind in the global financial system transition.

The opportunity for prudent climate risk management across the financial system

Alongside central banking and macroprudential work on climate risk, the Expert Panel should consider the application of stranded assets risk to national accounts, and risk analysis applied by Export Development Canada and other arms-length government financial entities in their respective credit risk analysis processes. For example, Statistics Canada includes the value of Canada's natural resource reserves as an asset in the National Balance Sheet Accounts, estimated at around $715 billion as of Q4/2018.[19] The Expert Panel should consider how Statistics Canada might revise its system of national accounts to incorporate downside risk of stranded fossil fuel assets being stranded, alongside other, physical climate shocks. By flagging the need for systems-level financial risk analysis and reporting in fixed income and other asset classes the Expert Panel would help increase the resilience of the Canadian economy to climate-related financial risks in a prudent manner.

The role of Forceful Stewardship in enabling authentic leadership on sustainable finance

Whilst today's dysfunctional politics have an addictive pull, the deeper reality is that climate policy is bound to change.[20] When the social tipping points that will drive this policy change will happen is hard to predict and so long-term investors would be wise to act within their sphere of legitimate influence to support the rapid energy transition now. Action by long-term investors would also make it more viable for policymakers to act on the Expert Panel's final recommendations.[21]

Forceful stewardship of investment assets especially by large, mainstream investors would demonstrate the kind of political stewardship that policy-makers need to show. Canada's largest public sector pension funds have been held up as global leaders on many traditional aspects of pension fund governance. They have, therefore, a particular interest in benchmarking globally vis-à-vis this non-traditional systemic risk. The decision by Caisse de dépôt et placement du Québec (CDPQ) to incorporate climate risk into investment decision-making and stewardship

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[18] Banque de France (2018) 'Publication of the mandates of the NGFS technical workstreams and expansion of the NGFS membership:' https://www.banque-france.fr/en/communique-de-presse/publication-mandates-ngfs-technical-workstreams-and-expansion-ngfs-membership

[19] For the current natural capital estimate see here: https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610058001; discussion on the methodology employed does not currently mention stranded asset risk: Statistics Canada 'Natural resource wealth statistics in the National Balance Sheet Accounts:' https://www150.statcan.gc.ca/n1/pub/13-605-x/2015009/article/14239-eng.htm

[20] PRI (2018) 'The Inevitable Policy Response' https://www.unpri.org/climate-change/the-inevitable-policy-response-to-climate-change/3578.article

[21] The Harvard Business Review (2016) 'The Climate Movement Needs More Corporate Lobbyists'; Sheldon Whitehouse: https://hbr.org/2016/02/the-climate-movement-needs-more-corporate-lobbyists

activities across different asset classes is a powerful example of movement in the right direction.[22]

"Forceful stewards" could be engaging with the largest Canadian fossil fuel companies but also heavy demand sector (eg transport, electric utility and mining) companies, using their influence to ensure business plays its full part in a rapid decarbonization and addressing systemic climate risk. In particular, Canada's largest financial players should be using their voting rights to send a public signal to drive deeper and faster corporate change in line with benchmarks being set by Climate Action 100+, an alliance of investors who are supportive of the Paris Agreement.[23] The scale of pension assets committed to change are indicated by the list of Canadian pension members of the Climate Action 100 Initiative - just less than 50% of total pension fund assets support this critical initiative.

Fund	**AUM (CDN$ billion)**
Canada Pension Plan Investment Board (CPPIB)	356
Caisse de dépôt et placement du Québec (CDPQ)	310
Ontario Teachers' Pension Plan (OTPP)	190
PSP Investments	153
British Columbia Investment Management Corporation (BCI)	135
Alberta Investment Management Corporation (AIMCo)	100
Ontario Municipal Employees' Retirement System (OMERS)	97
Healthcare of Ontario Pension Plan (HOOPP)	79
British Columbia Municipal Pension Board of Trustees	51
Ontario Pension Board	26
OPTrust	20
Total	**1,517 (706)**

Table 1: The largest Canadian pension funds manage over $1.5 trillion in assets. Canadian members of the Climate Action 100 Initiative are highlighted in yellow: http://www.climateaction100.org/

[22] CDPQ (2018) 'Stewardship Investing Report' https://www.cdpq.com/en/investments/responsible-investment

[23] http://www.climateaction100.org/; The Economist (2019) 'Oil majors face shareholder resolutions on climate change' https://www.economist.com/business/2019/05/30/oil-majors-face-shareholder-resolutions-on-climate-change

Forceful stewards should also engage with all the other players involved in the investment chain – from research analysts to investment consultants to regulators – to ensure that they, too, play their part in addressing systemic risks to financial stability and long-term prosperity. The Sunrise movement in the United States, and the prominent discussion of Green New Deal policy options there suggests that something similar could occur in Canada if the financial sector chose to wield its influence to drive climate-aligned public policy formation.[24]

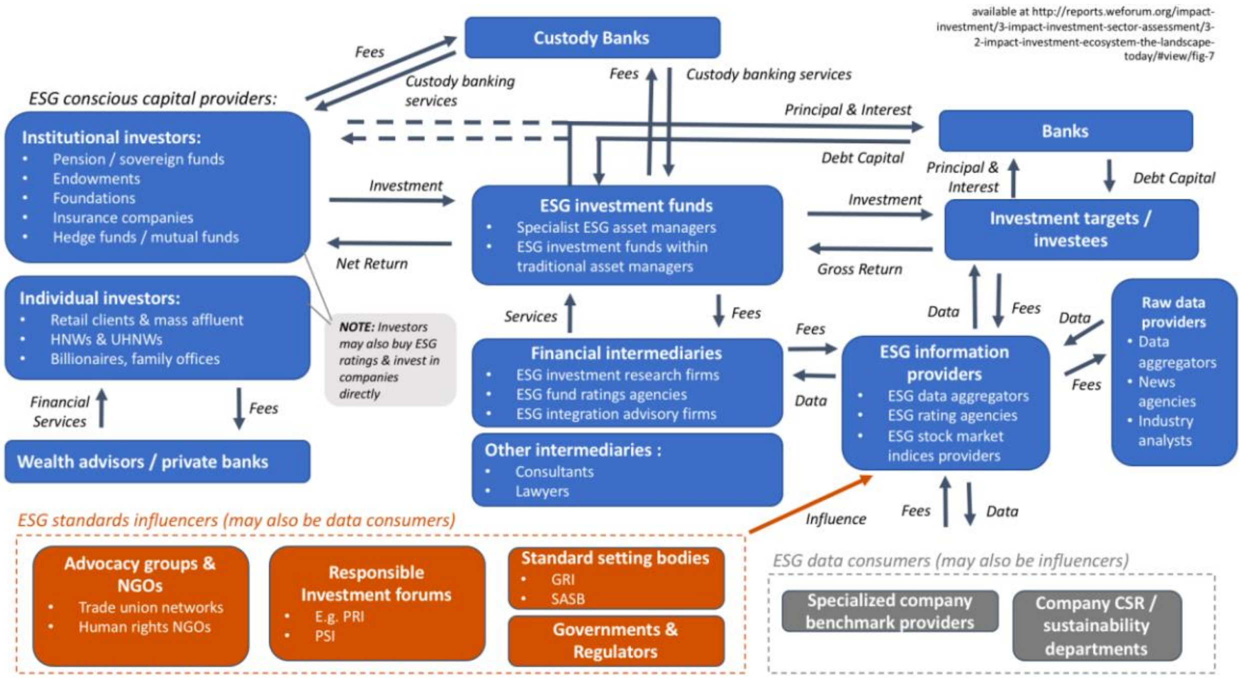

Figure 1 - **Key links in the institutional investment chain.** Institutional investors acting as forceful stewards can exert influence through the institutional investment chain, including the stakeholders indicated above. From Ruggie et al (2018) 'Money, Millennials and Human Rights: Sustaining 'Sustainable Investing':' https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/working.papers/CRI69_FINAL.pdf

Other long-term investors should also be showing more robust stewardship in response to the climate crisis and the need for a rapid energy system decarbonization that aligns to net zero GHG emissions by 2050. This is particularly relevant to: index investors (who cannot exit and therefore must use their voice); active investors (who hold overweight positions in the largest Canadian companies in the energy and finance sectors presumably because they think these companies are well run); and private equity investors (who have a powerful insider role in determining management conduct and the ability of the most distressed segments of the North American fossil fuel sector to continue accessing debt markets).

The Canadian Expert Panel could make it easier for the country's largest financial players to commitment to forceful stewardship by acting on stakeholder recommendations on the creation

[24] In Canada, the Green New Deal remains a political orphan, in spite of the efforts by The Leap and others to create a continental political movement for action on this agenda: https://theleap.org/portfolio-items/green-new-deal/

of a robust Canadian Stewardship Code following the UK model but with more robust disclosure and transparency provisions.[25] Even if it does not recommend the creation of an assertive Canadian Stewardship Code, this would not justify long term, responsible investors shirking their fiduciary duty to prudently manage climate-related financial risks, including through their stewardship activities.

Canada needs to show meaningful leadership globally, not retreat into parochialism

Professor Macklem's comments indicate a risk that Canada might end up joining a club of petro-economies that are committed to the continued extraction of fossil fuels, regardless of the damage this will cause to the ecosystem and biodiversity, the global economy and human civilisation in the medium term. This approach will not help Canada's financial sector thrive globally, much less to help create a climate system that is fit for human civilisation. If the preoccupation with 'Made in Canada' solutions to the global climate crisis dominate in the final report, clearly there will be much room for progress in defining and setting standards for sustainable finance in Canada.

To summarise, the Canadian financial system has a choice. It can either align with climate leaders globally (ie Europe and China) or it can align with the laggards (ie Australia, Brazil, Russia, Saudi Arabia and the USA, at least till 2020). Whilst culturally tempting to search for a "middle of the road" option, this is an illusion and would simply mean going off the climate cliff more slowly than the laggards would like. Given what we now know about the climate and biodiversity crises,[26] predatory delay and incrementalism is the new denialism. In the context of rising populism, Canada – with a public that is (relatively speaking) supportive of climate action[27] – has a unique opportunity to help take the world off the catastrophic path that is currently on and lead the global transition towards a more sustainable and equitable financial system.

[25] A Canadian Stewardship Code would apply to institutional investors (for example, pension funds and insurance companies) and their service providers (investment managers and investment consultants), similar to the UK Stewardship Code. A Canadian Stewardship Code could build on the UK experience and enhance the transparency and effectiveness of disclosure through the institutional investment chain. For analysis on the UK experience since the introduction if an investor stewardship code there in 2012, see: https://www.frc.org.uk/investors/uk-stewardship-code

[26] UN (2019) 'UN Report: Nature's Dangerous Decline 'Unprecedented'; Species Extinction Rates 'Accelerating:' https://www.un.org/sustainabledevelopment/blog/2019/05/nature-decline-unprecedented-report/

[27] IPSOS (2018) 'Climate Change Mired as a Relative Non-Issue Worldwide' https://www.ipsos.com/sites/default/files/ct/publication/documents/2018-01/public-perspectives-climate-change-2018-01.pdf