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Sustainable Investing Perspectives: COP26 Special Edition

Sustainable investing

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- The 26th Conference of the Parties is coming up, and in this report we highlight key topics that the conference will address and what they mean for investors.
- COP26 will be an influential event that coordinates global efforts to achieve the goals set out by the Paris Agreement.
- Four goals have been outlined for the conference: mitigation, adaptation, finance, and collaboration. In this report we cover what to watch out for as the conference takes place and how investors can take advantage of the opportunities created in the ESG space.

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A refresher: What are the COP26 meetings?

The 26th Conference of the Parties (COP) is set to take place from 31 October until 12 November. Signatories of the United Nations Framework Convention on Climate Change (UNFCCC) will use this COP to coordinate, design, and review plans that address the risks of climate change. Delegates from more than 190 countries will gather in Glasgow to formally negotiate and put together new goals.

The first COP was held in 1995, and other key events include COP3, where the Kyoto Protocol was adopted, which introduced the first greenhouse gas emission objectives as well as emission trading mechanisms. The Paris Agreement was adopted at COP21 in 2015, which introduced the goal to keep the rise in global average temperature to well below 2 degrees Celsius, and preferably limit it to 1.5 C. The agreement requires all signatories to determine and submit their individual climate action plans, called Nationally Determined Contributions (NDCs), every five years.

COP26, as the first opportunity to take stock of NDCs from all countries, will play a crucial role in aligning global efforts to work toward the goals set out by the Paris Agreement. As of June this year, 59 countries representing nearly 55% of global greenhouse gas emissions have communicated net-zero commitments by 2050.[1] With global energy prices squeezing higher in recent weeks, the tension between energy security and emissions reduction ambitions will undoubtedly be a focal point for the event, even as the latest Intergovernmental Panel on Climate Change (IPCC) report, published this August, suggests that irrevocable tipping points can be reached as soon as 2030.[2]

With this backdrop, we expect policymakers to be pressed to deliver more clarity and practical strategies to support lofty decarbonization ambitions.

Four goals are outlined for the conference: mitigation, adaptation, finance, and collaboration. Mitigation addresses the challenge of achieving net-zero by 2050 through drastic emissions reductions, in order to keep the global average temperature rise of 1.5 C goal within reach. Meanwhile, although countries and companies are working on reaching net-zero by 2050, the climate is already

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changing. The second goal of COP26, adaptation, is to prepare and protect communities and natural habitats from this changing climate. The final two goals, finance and collaboration, focus on delivering on the first two goals. In 2009, developed countries agreed to mobilize USD 100bn in climate finance per year by 2020. COP26 will be used to find ways to continue this mobilization, as well as to outline what role financial institutions can play in reaching global net-zero.

Investors, corporations, and the broader public will all gather in Glasgow, but the 10-day meeting will focus on high-level negotiations between countries whose leaders are balancing the risks of climate change with near-term domestic political priorities. Countries understand that emissions do not stop at national borders, helping create favorable conditions for "climate diplomacy," as we have seen in commitments to cooperate between China and the US. Yet, domestic pressures are likely to come to the surface in the international forum.

For example, although President Joe Biden's own green policy agenda is likely to retain many key provisions to drive decarbonization, its ambitions have been pared down from initial proposals. The US is also unlikely to support a carbon border tax, a key policy tool to drive down global emissions that is part of the European Union's own proposals. President Xi Jinping has committed to peaking Chinese coal production by 2030 and achieving net-zero by 2060. However, a recently released official progress report showed that most provinces lagged behind their annual energy intensity reduction targets. This, combined with reeling energy prices, have led to power rationing and cuts enforced at the provincial level. While we expect China to keep its commitments in the month leading to Glasgow—which is also evident in its recent decision to introduce differentiated power pricing for high energy-intensity sectors, and is paving the way for power tariff liberalization—it nonetheless paints in stark reality the Herculean challenge ahead.

The EU Commission is focused on implementing the bloc's objective to cut emissions by 55% by 2030 through an ambitious policy package that will only be voted next spring. Leaders from emerging markets, where energy intensity (the units of energy consumed for every unit of GDP) is often higher, are likely to come to Glasgow looking to advocate for more gradual decarbonization paths for them and generate commitments for support from developed markets.

Now that we have context on COP26, let us look at what we expect from the meeting.

Mitigation and adaptation

The results of decades of record emissions are already noticeable, as the surface temperature of the planet has increased rapidly over the past century. Relative to the 1850–1900 average, the planet has warmed by 1.2 degrees Celsius, with current policies putting the planet on track for 2.9 C warming by 2100.[3] We're watching the following four topics related to mitigation and adaptation at the conference:

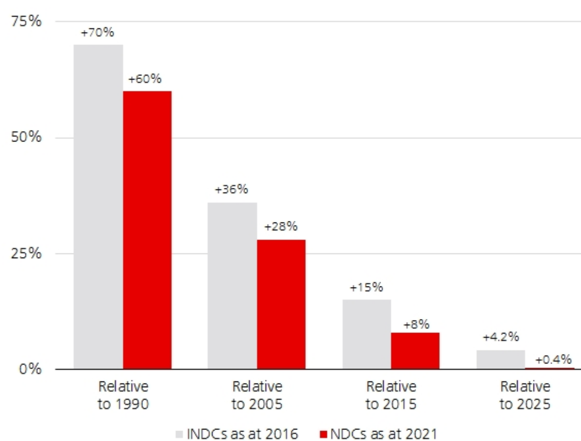
1. Aligning around 1.5 C—is it still possible?

Mitigation, or keeping a global average temperature rise of 1.5 C within reach, and achieving net-zero emissions will be a key discussion topic. The IPCC report found that immediate and large-scale reductions in greenhouse gas emissions are required to achieve this objective. A possible outcome of Glasgow will be for countries to agree to setting 1.5 C as the objective, instead of planning to remain within the more feasible 2 C scenario.

More than 130 countries have already set, or are considering, a target to reduce emissions to net-zero by 2050. However, the UN NDC Synthesis Report, which analyzed all NDCs submitted by 190 countries as of 30 July, found that: 1) country commitments in 2021 were more ambitious than in 2016, in line with the Paris Agreement mechanism; and 2) even if successfully implemented, these commitments imply an *increase* of 60% over 1990 levels by 2030 (Fig. 1).[4]

Fig. 1: Nationally Determined Contributions have become more ambitions but still imply an average increase in CO2 emissions by 2030

Target emissions for 2030 are lower than under previous plans, but still 60% above 1990 emissions.



Source: UNFCCC, UBS

Chart shows the increase in CO2 emissions compared to the baseline year that is implied from the global NDC reports.

The reality of the NDC report highlights the urgency behind generating additional commitments in Glasgow. However, it also highlights that the pace and practical plans to achieve decarbonization targets are more meaningful for investors

than the targets themselves. The more aggressive objective would imply a willingness for economies to undergo a drastic transition, through legislation, consumption patterns, investments, and others. The recent global energy crisis, which is partly driven by structural underinvestment that constrained fossil fuel supply, is testament to the potential GDP sacrifice and volatility that would have to be managed in this transition. All sectors are therefore, to some extent, exposed to *transition risk*: the risks faced in transitioning to a low-carbon economy. Both countries and companies would have to make clear and transparent short-, medium-, and long-term plans to manage these risks.

Investor takeaway:

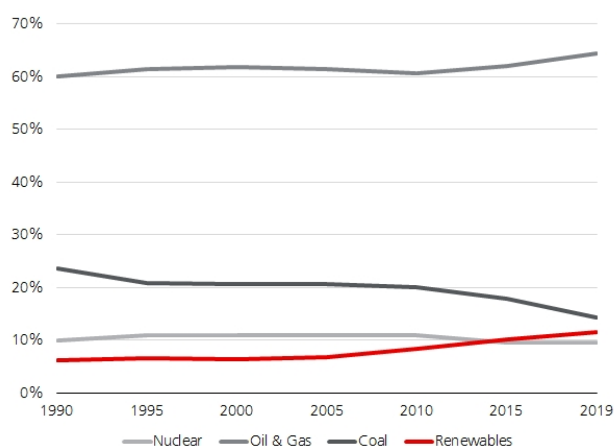
- Environmental, social, and governance (ESG) leaders with more robust climate and transition policies are likely to prove more resilient amid both rising climate risks and potential regulatory tightening in support of the energy transition.

2. Global energy mix and phase-out of coal—by when?
Against a backdrop of volatility in energy prices in September and early October, we expect the energy mix and phase-out of coal to be at the heart of negotiations in Glasgow. In the UK, this energy transition is well underway, as the country has significantly increased its energy generation from renewables (hydro, wind, and solar). In 2020, 25% of the UK's energy was generated by renewable sources, compared to 2% in 2010. Across OECD countries, the energy mix is also changing (Fig. 2)—contribution from renewables is increasing, while fossil fuels, especially coal, are gradually phasing out. Yet, non-OECD countries have seen an increase of both energy demand and use of fossil fuels, and we estimate that it would take at least 20 years for global economies to fully reduce our fossil fuel dependency, even assuming 12% annual growth in renewable energy capacity (on a 10-year average). This makes a rapid transition more economically painful absent much faster investment in renewable energy (Fig. 3).

We expect COP26 to fuel increased commitments to accelerate the phasing out of coal in major economies, with natural gas likely to be positioned as a transitionary resource, although not an uncontroversial one. The timeline of commitments will also be key to understanding whether governments will aim to peak coal consumption organically, given existing growth and investment projections, or at an accelerated timetable, implying a need for renewable energy capacity to increase. Yet, this recent surge in coal and natural gas prices will serve as a vivid reminder of the complexity of the climate transition for policymakers in Glasgow. For more on our assessment of peak energy prices, see "Energy: The perfect storm—what next?"

Fig. 2: OECD countries total energy supply

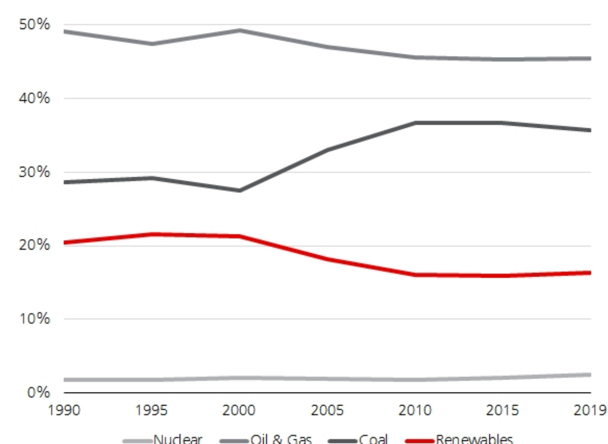
Coal is losing ground to renewables, but oil and natural gas still fuel rich countries.



Source: IEA, UBS

Fig. 3: Non-OECD countries total energy supply

Fossil fuels have maintained a prominent role as energy demand has increased



Source: IEA, UBS

Investor takeaway:

- The pace of renewables deployment would likely be further accelerated against this backdrop, as renewables become increasingly attractive not only for the lower emission profile but as rising energy volatility lowers operating-expense visibility. Please refer to our "Greentech goes global" investment opportunities report, as well as our *Longer Term Investments* (LTI) themes "Clean air and carbon reduction" and "Smart mobility."

3. Setting a price on carbon—where and how much?
The main way in which governments can change corporate emissions is by putting a price on carbon. Currently, two popular approaches exist: emissions trading systems (ETS)

and carbon taxes. Globally, over 20% of global emissions are priced. The increase in sectors covered by these mechanisms, as well as increasing prices, is a significant part of the transition risk companies face. As the prices per ton of CO_2 increase and emission limits tighten, the pressure on company profitability will grow, encouraging businesses to make their operations more efficient. We prefer companies that are ESG leaders in managing their carbon emissions, as they are more likely to be relative beneficiaries of expanded ETS.

Carbon offsets are likely to be an important part of the climate transition, but present risks if they result in "carbon leakage" (an increase in CO_2 emissions in a jurisdiction adjacent to one creating credits), use of already retired carbon credits, and others. Therefore, we expect governments and the private sector to increasingly collaborate on stricter standards that would bring welcome transparency to investors, and create additional liquidity in global voluntary carbon markets. For a primer on emissions trading and EU ETS, please see the report "Introduction to the European carbon market."

Global carbon taxes, including carbon border adjustment taxes (carbon taxes levied where the good is consumed, not produced), a policy proposed by the EU Commission, are another hot-button question with investor implications. We do not see global agreement on carbon border adjustment taxes as likely, in particular given signaling from the US administration.

Investor takeaway:

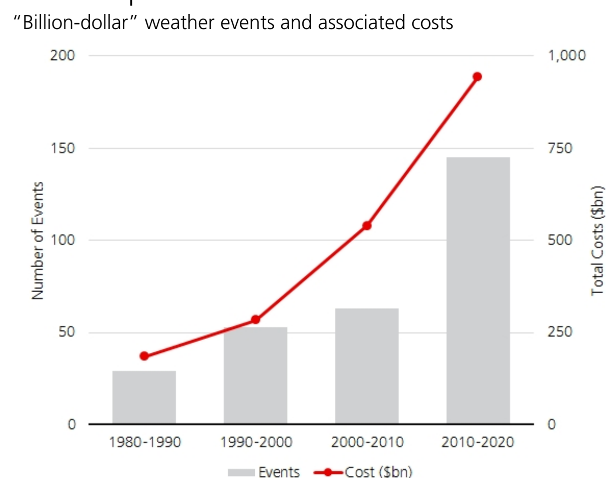
- ESG leaders with lower carbon intensity and better energy management policies would be more resilient as carbon pricing ramps up globally.

4. Adaptation—where are opportunities?

While it is important to prepare for an economy in transition, companies and investors should recognize that the world's climate is already changing. Extreme weather events are becoming more common and more costly. Companies and investors are exposed to *physical risk*: the damage to business continuity, asset values, and productivity, caused by rising temperatures and the associated effects (e.g., wildfire, flooding, sea level rise). Extreme weather events are becoming more common and costly (Fig. 4), with their frequency and associated costs expected to increase as a result of rising global temperatures.

Fig. 4: Extreme weather events have become more frequent and severe

"Billion-dollar" weather events and associated costs



Source: NOAA, UBS

The second point on the COP26 agenda, adaptation, addresses this challenge. Through adaptation, governments aim to protect and adapt communities and natural habitats from the changing climate. Adaptation financing is important today, but it will be particularly pressing if the 1.5 C and 2 C scenarios slip out of reach. We expect emerging market governments and countries most vulnerable to the changing climate to allocate or incentivize increased adaptation-related funding.

One estimate of the annual cost of adaptation is USD 140–300bn, from a 2017 report by the UN Environment Program Finance Initiative, presenting an opportunity for companies that can bring to market adaptation solutions.[5] Yet, this figure is likely to be much higher given increased costs of climate-related events (Fig. 4). Investment opportunities range from infrastructure, to water, to agricultural system resilience. As one example, in New Orleans, one of the cities hit hardest by Hurricane Katrina in 2005, 560km of flood walls and levees were built to protect the city from future surge waters. The total investment associated with the project reached USD 14.5bn.[6]

In addition to opportunities, investors should consider whether the companies they are invested in have assessed which facilities are most exposed to this physical risk, and will want to consider moving or insuring their operations. Climate-related losses in 2020 were estimated to be USD 210bn, but just 40% of the losses were insured globally, and even less so in emerging markets (just 2% in China).[7] Investors can adjust their portfolios to more climate-resilient companies and regions, to limit potential downside from physical risk. Equity and real estate portfolios with facilities in coastal areas, or regions exposed to other extreme weather conditions, are likely to be impacted if there is no sufficient adaptation.

Finally, green, sustainability, and sustainability-linked bonds are likely to be an important part of the toolkit as governments and companies look to adapt to the changing climate conditions.

Investor takeaways:

- Adaptation focuses on holistic resilience. Investors may consider positioning for climate resilience through a 100% sustainable investing portfolio, balancing exposure to solutions (through ESG themes), more resilient companies (ESG leaders and improvers), emerging market development projects (MDB bonds), green bonds, and potentially drive positive change through ESG engagement

Financing and collaboration

The next two goals of COP26 are aimed at raising additional private and public capital to support developing countries in climate mitigation and adaptation. More so, they encourage further global alignment on common standards related to climate financing; innovation; transparency between governments and of the private sector; and global carbon credit systems. The goal of collaboration will permeate every other discussion at the climate summit.

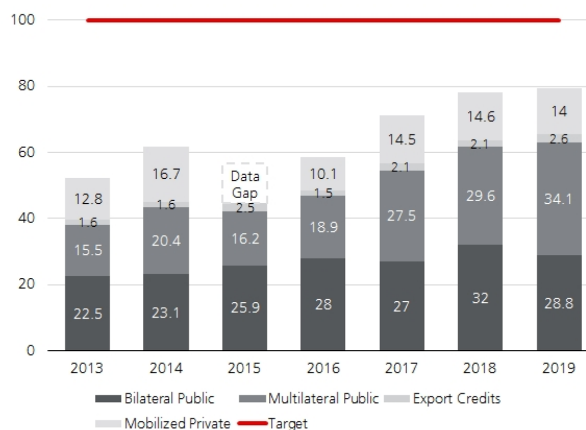
In 2016, developed economies committed to raising USD 100bn annually in climate financing. According to the OECD, the actual amount raised has increased year over year since, but not yet reached the target (Fig. 5). Ahead of Glasgow, the UK has doubled its commitment to GBP 11.6bn over five years, and the EU has committed EUR 28bn in total between 2021 and 2026 in addition to climate finance from the European Investment Bank, among other countries that have also ramped up their commitments already. Yet, the current pledges still fall short of the objective, making this a topic to watch with important implications for emerging markets in particular.

Investor takeaway:

- We expect climate finance to accelerate, which is supportive of rising issuance of sustainable bonds. We prefer sustainable bonds on a *pari passu* basis.

Fig. 5: Climate finance raised to support developing countries has increased over time

Total assets raised increasing (in USD bn), but short of USD 100bn goal



Source: OECD, UBS

[1] World Resources Institute, 2021.

[2] Climate Action Tracker, 2021.

[3] Intergovernmental Panel on Climate Change, 2021.

[4] The UN will update the report with another round of submitted commitments on October 25.

[5] https://www.unepfi.org/climate-change/adaptation/gca-adaptation-finance-background-paper/

[6] Reuters, 2021.

[7] Munich Re Institute, 2018.

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