7th Annual Conference on Investment Treaties

Investment treaties and climate change

The Alignment of finance flows under the Paris Agreement

Background note

10 May 2022
Virtual conference

This note provides background for participants in the seventh annual OECD Investment Treaty Conference dedicated to Investment treaties and climate change, and in particular for participants in the session on the alignment of finance flows with the Paris Agreement and Net Zero. The Conference is scheduled for 10 May 2022 and the draft agenda is available on the Conference webpage (https://oe.cd/IIA-conf). The note will also support inter-governmental and other discussions. An earlier version of this note was discussed by governments, stakeholders and experts at a meeting held under Chatham House rules in April 2022.

The note should not be described as representing the official views of the OECD or of governments participating in its work on investment. The opinions expressed and arguments employed are those of the author.

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1. Introduction

1. The 2015 Paris Agreement set out two fundamental and innovative goals for government climate policies. First, governments set for the first time the clear objective of less than 2 degrees Celsius warming, with the stretch objective of 1.5 degrees. In the years since the Paris Agreement was signed, the need to limit warming to 1.5°C has become even stronger.[1]

2. Second, governments expressly agreed on the objective to make "finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development". Paris Agreement, art. 2.1(c) (emphasis added). This core objective, set out in the same article as the temperature goals, has two elements – a focus on finance flows and the aim to align them to low emissions.

3. Action to align finance flows under the Paris Agreement has become increasingly urgent as the climate context has worsened. To achieve the goal of limiting warming to 1.5 degrees, it is now generally recognised that global greenhouse gas (GHG) emissions will need to be 'net zero' by 2050.[2] Yet global emissions continue to accumulate rapidly, with 2021 emissions expected to be only slightly lower than the record 2019 levels. UNEP reports that a 55% reduction in emissions by 2030 en route to zero in 2050 is needed to remain on track.[3]

4. A broad range of public and private financial actors have responded to the urgency of aligning finance flows with a low-carbon trajectory, widely taken today to require net zero. Attention has expanded from environment ministries to finance ministries and central banks. For example, the Coalition of Finance Ministers for Climate Action now includes 65 member countries representing over 39% of global carbon emissions and 63% of global GDP (2018). Members have "committed to working collectively toward mainstreaming climate into economic policies … and meeting key climate goals (including net zero emissions)".[4]

5. While just a few years ago financial actors such as banks or insurers generally considered that GHG emissions were an issue primarily for operating companies or

[1] The 2018 Special report on 1.5°C by the Intergovernmental Panel on Climate Change (IPCC) reflected a scientific consensus that (i) impacts to human health, society, and nature associated with 1.5°C of warming are worse than previously acknowledged; and (ii) the risks associated with exceeding 1.5°C are far higher. Consequently, the report highlighted pathways that limit warming to 1.5°C with no or limited overshoot (overshoot <0.1°C). See IPCC, Global Warming of 1.5°C, a Special Report (2018); CDP, Foundations for Science-Based Net-Zero Target Setting in the Corporate Sector (2020), p. 19. It is generally recognised that to achieve 1.5 degrees, global greenhouse gas emissions will need to be 'net zero' by 2050.

[2] In the years since the Paris Agreement was signed, the need to limit warming to 1.5°C has become even stronger. The 2018 Special report on 1.5°C by the Intergovernmental Panel on Climate Change (IPCC) reflected a scientific consensus that (i) impacts to human health, society, and nature associated with 1.5°C of warming are worse than previously acknowledged; and (ii) the risks associated with exceeding 1.5°C are far higher. Consequently, the report highlighted pathways that limit warming to 1.5°C with no or limited overshoot (overshoot <0.1°C). See IPCC, Global Warming of 1.5°C, a Special Report (2018); CDP, Foundations for Science-Based Net-Zero Target Setting in the Corporate Sector (2020), p. 19.

[3] UNEP, Emissions Gap report 2021, Executive Summary, pp. v, xi.

[4] See Joint Ministerial Statement, The Coalition of Finance Ministers for Climate Action (12 October 2021).

consumers, today it is today increasingly recognised that financial actors that provide financial services to entities that produce GHG emissions "own" part of those emissions. There is intensive work on how to measure and compare the responsibilities of different financial actors for their "financed emissions". But the basic principle is increasingly well-established: if you finance it, and it produces emissions, you own part of those emissions.

6. The logic of financed emissions applies today across the finance sector and in particular to asset owners, lenders and insurers. A growing number of financial actors are making commitments to align their financed emissions, including their insured emissions, with net zero, taking concrete action and reporting on their progress. This involves commitments and action to align their portfolios of counterparties.

7. Private initiatives are not sufficient to align finance flows with net zero, as the Group of Thirty (composed primarily of current and former central bankers) has underlined:

> ***Public policy has to shape the incentives for the transition. Public policy has to provide the foundation for a transition to net zero.*** *Our climate is a public good. Private companies and financial institutions will not fully take the impact of their actions on our climate into account unless public policy forces them to do so. Leading businesses can accelerate change by anticipating future climate policies and adapting to them today. Ultimately, however, there is no substitute for effective, predictable, and credible public policies.*[5]

8. Investment treaties form an important part of the public policy framework for finance flows with climate consequences. Yet the application of the art. 2.1(c) finance flows provision of the Paris Agreement has received limited attention in investment treaty reform. This paper considers the relevance of art. 2.1(c) and related developments for the investment treaty regime. Given the role of investment treaties for finance flows, this is important, urgent, and reinforced by the commitments of major economies to climate action across their foreign, security and trade policies.[6]

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5 Group of Thirty, Mainstreaming the Transition to a Net Zero Economy (2020) pp. xii, xiii (emphasis in original). The report was produced by the Group of Thirty's Steering Committee and Working Group on Climate Change and Finance.

6 For example, in January 2021, the Council of the EU (composed of all EU Member State Foreign Ministers) stressed that the EU "will ensure that its trade policy and its trade agreements are consistent with its climate ambition,"; the coherent pursuit of external policy goals is identified as crucial for the success of the European Green Deal. See Council adopts conclusions on climate and energy diplomacy (25 Jan. 2021) (press release); Climate and Energy Diplomacy - Delivering on the external dimension of the European Green Deal (Jan 2021) (Council conclusions). In the United States, President Biden has announced a "whole-of-government approach to put climate change at the center of our domestic, national security, and foreign policy". Remarks by President Biden Before Signing Executive Actions on Tackling Climate Change, Creating Jobs, and Restoring Scientific Integrity (27 Jan. 2021). During COP26, twenty countries, including the US, Germany, France, the UK, Italy and Canada have pledged to end new direct public support for the international unabated fossil fuel energy sector by the end of 2022, except in limited and clearly defined circumstances that are consistent with a 1.5°C warming limit and the goals of the Paris Agreement; China, Japan and the Republic of Korea have committed more narrowly to cease public support for coal investments abroad. See Statement on International Public Support for the Clean Energy Transition (4 Nov. 2021); see Leslie Hook, US, UK and others to end overseas fossil fuel financing in 2022 (Financial Times 4 Nov. 2022).

9. For investment treaties, consideration of alignment of finance flows requires attention to the scope of covered investment and other treaty provisions and policies that may determine the climate characteristics and Paris alignment of the portfolios of counterparties and finance flows at issue.[7] It can help governments and others consider whether investment treaty policies need to be aligned with the Paris Agreement and net zero[8], current degrees of alignment and possible areas for action.

10. The balance of this paper will first address the growing body of public, private and joint work on finance flows and the climate since the 2015 Paris Agreement. This includes development of the notion of financed emissions, and the recent rapid expansion of action from disclosure to commitments to align with the Paris Agreement and net zero. The paper then considers investment treaties and Paris alignment of finance flows.[9]

2. Increasingly intensive work on finance flows and the climate since 2015

2.1. The Task Force on Climate-Related Financial Disclosures (TCFD)

11. In April 2015, G20 Finance Ministers and Central Bank Governors asked the Financial Stability Board (FSB)[10] to convene public- and private-sector participants to review how the financial sector can take account of climate-related issues. As part of its review, the FSB identified the need for better information to support informed investment, lending, and insurance underwriting decisions and improve understanding of climate-related risks.

12. To help identify the information needed to assess and price climate-related risks, the FSB established an industry-led task force — the Task Force on Climate-Related Financial Disclosures (TCFD). The FSB asked the TCFD to develop voluntary climate-related

7 As discussed further below, counterparties in this context refers to the recipient of financial services. For investment treaties, counterparties are covered investors.

8 The discussion considers only policy responsibilities. No view is expressed about possible legal responsibilities if any.

9 The finance flows provision and a number of other provisions in the Paris Agreement may also be relevant to the preservation and encouragement of government policy space to adopt climate-friendly measures. Policy space is a vitally important climate policy topic and will be addressed in a dedicated session during the 10 May 2022 Investment Treaty Conference. (https://oe.cd/IIA-conf) OECD analytic papers and recent news articles have discussed the potential for treaty-covered claimants to use ISDS to challenge government regulatory measures including climate-related measures. A number of contributors to the Jan.-Mar. 2022 OECD public consultation on Investment treaties and climate change have also addressed policy space issues and concerns, and can provide input into the Conference discussions and following work. In light of this and other existing work on policy space and less attention to date on issues of Paris Agreement alignment of portfolios of counterparties under investment treaties, this paper focuses on the latter issue.

10 The FSB is an international body that monitors and makes recommendations about the global financial system. The FSB has 68 member institutions, comprising ministries of finance, central banks, and supervisory and regulatory authorities from 25 G20 and other jurisdictions as well as 10 international organisations and standard-setting bodies (including the OECD), and 6 Regional Consultative Groups reaching out to 65 other jurisdictions around the world.

financial disclosures that would be useful to investors and others in understanding material risks.[11]

13. In June 2017, the TCFD released its final Recommendations, providing a global framework for companies and other organizations to develop more effective climate-related financial disclosures.[12] In its report, the TCFD emphasized the importance of transparency in pricing of risk — including risk related to climate change — to support informed, efficient capital allocation decisions. The TCFD disclosure recommendations are structured around four thematic areas that represent core elements of how organizations operate: (i) governance; (ii) strategy; (iii) risk management; and (iv) metrics and targets. These thematic areas are intended to overlap and relate to each other.

14. The TCFD recommends that organisations calculate their GHG emissions in line with the widely-used GHG Protocol methodology.[13] Under the GHG Protocol, greenhouse gas emissions are generally categorised into three groups or "scopes". Scope 1 covers direct emissions from owned or controlled sources. Scope 2 covers indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the reporting company. Scope 3 includes all other indirect emissions that occur in an organisation's value chain. Use of the GHG Protocol allows for aggregation and comparability across organisations and jurisdictions.[14]

15. For financial actors that influence finance flows, climate accountability is based on their portfolios. A recent Carbon Disclosure Project (CDP) study finds that GHG emissions associated with lending, underwriting and investment portfolios are more than 700 times higher, on average, than a financial institution's direct emissions.[15]

16. At the request of the FSB, the TCFD has issued four annual status reports. They document how global momentum has grown behind the TCFD's work and is rapidly accelerating. The 2021 report notes that TCFD supporters now span 89 countries and jurisdictions and nearly all sectors of the economy, with a combined market capitalization of over $25 trillion — a 99% increase since 2020.[16] The more than 2,500 supporters, including 1,069 financial institutions, are responsible for assets of $194 trillion. The CDP has

[11] Task Force on Climate-related Financial Disclosures, 2021 Status Report, p.2.

[12] Recommendations of the Task Force on Climate-related Financial Disclosures (2017).

[13] See TCFD, Metrics and Targets.

[14] The TCFD developed supplemental guidance for sectors of particular importance such as the financial sector. It organized the financial sector into four major industries largely based on activities performed: banks (lending); insurance (underwriting); asset managers (asset management); and asset owners (including public- and private-sector pension plans, endowments, and foundations (investing)). The TCFD also developed supplemental guidance for the four non-financial industry groups that account for the largest proportion of GHG emissions and energy and water usage: (i) energy; (ii) materials and buildings; (iii) transportation; and (iv) agriculture, food, and forest products. Recommendations of the Task Force on Climate-related Financial Disclosures (2017), p.15.

[15] See Carbon Disclosure Project, The Time to Green Finance: CDP Financial Services Disclosure Report 2020, (analysis based on self-reported data from 332 financial institutions -- global asset managers, asset owners, insurers and banks -- representing USD 109 trillion of assets), cited in PWC, supra.

[16] Task Force on Climate-related Financial Disclosures, 2021 Status Report, p. 2.

documented a rapid increase in TCFD-aligned reporting through CDP in the Asia-Pacific region with many companies in China, India and Southeast Asia reporting information for the first time in 2020. The region now accounts for nearly 30% of CDP's global corporate responses.[17]

17. Regulators and legislators have embraced the process as well. France was the first country in the world to adopt a law requiring "green transparency" as part of its 2015 Energy Transition for Green Growth Act. Article 173 of the law introduced a climate risk reporting obligation. It has inspired broader action and has now been replaced by a EU regulation that establishes a common standard for reporting on financial products in EU countries. The European Commission set up a Technical expert group on sustainable finance (TEG) to assist it in developing, in line with the Commission's legislative proposals of May 2018, (i) an EU classification system – the so-called EU taxonomy – to determine whether an economic activity is environmentally sustainable; (ii) an EU Green Bond Standard; (iii) methodologies for EU climate benchmarks and disclosures for benchmarks; and (iv) guidance to improve corporate disclosure of climate-related information. The European Union proposed a new Corporate Sustainability Reporting Directive in 2021 along with other measures.[18]

18. Apart from the EU, multiple other jurisdictions have proposed or finalized laws and regulations to require disclosure aligned with the TCFD Recommendations, including Brazil, Hong Kong China, Japan, New Zealand, Singapore, Switzerland and the UK.[19] Many central banks, supervisors and regulators have also formally expressed support for the Recommendations.[20] The TCFD Recommendations are also a basis upon which international accounting standard setters are building global standards for climate risk disclosure.[21]

19. In June 2021, G7 Finance Ministers and Central Bank Governors supported "moving towards mandatory climate-related financial disclosures that provide consistent and decision-useful information for market participants and that are based on the [TCFD] framework, in line with domestic regulatory frameworks."[22]

20. The US Securities and Exchange Commission (SEC) published in March 2022 a new proposed rule for listed companies that would require enhanced climate-related disclosures "similar to those that many companies already provide based on broadly accepted disclosure frameworks, such as the [TCFD] and the [GHG] Protocol".[23] Multilateral development

17 See Pratima Divgi, Asia Pacific's Race to Net-zero: CDP's Regional Analysis of 2020 Corporate Environmental Disclosures (13 May 2021).

18 See European Commission Press Release IP/21/1804, Sustainable Finance and EU Taxonomy: Commission takes further steps to channel money towards sustainable activities (April 2021).

19 See TCFD 2021 Status Report, Figure ES2 "Announcements of Official TCFD-Aligned Reporting Requirements".

20 Id., p.1. Central banks are also beginning to conduct climate stress tests for lenders and insurers, and some are examining how to revise their monetary policy operations to be more consistent with the legislated climate objectives and policies in their jurisdictions.

21 Id., Table ES1 "Support from International Standard Setters and Regulators for TCFD".

22 G7 Finance Ministers and Central Bank Governors Communiqué (5 June 2021), para. 4; see id. para. 7.

23 US Securities and Exchange Commission, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (21 Mar. 2022).

banks, including most recently the Asian Development Bank, have also declared support for TCFD disclosures.[24]

21. In addition to the high-level TCFD Recommendations, there are today five main third-party standards and frameworks for climate-related disclosures, namely the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), International Integrated Reporting Council (IIRC), Climate Disclosure Standards Board (CDSB) and Carbon Disclosure Project (CDP). A recent FSB survey of governments indicates that where these third-party frameworks are used by governments, it is typically done in conjunction with TCFD Recommendations rather than as an alternative.[25]

Box 1. Key concepts: Financed emissions and insured emissions

The GHG emissions associated with a given provision of financial services to an entity or project are frequently referred to as financed emissions. For example, if a bank extends a loan to an oil and gas firm, and that firm produces a set amount of greenhouse gasses, the financed emissions of the bank will then include a fraction of its counterparty's emissions.

As noted by an auditing firm, "[i]In current carbon accounting models, ownership of GHGs associated with investments and lending activities is considered part of a financial institution's carbon footprint. Specifically, GHG protocol accounting standards define these GHGs as Scope 3 Category 15 emissions, or financed emissions. Lending and investment are not the only sources of carbon in financing. Insurance underwriting, for example, is another source that regulators and industry groups recommend considering when assessing and mitigating climate risks." See PWC, "Financial institutions are pledging to lower carbon footprints. Here's what you need to know about financed emissions".

Standards for estimating financed emissions within a portfolio are under development. Currently, GHG Protocol accounting standards require accounting for financed emissions associated with equity investments, loans with a known use of funds and project finance. For other financed

[24] See Asian Development Bank, ADB Announces Support for Task Force on Climate-Related Financial Disclosures (26 Nov. 2021).

The European Investment Bank formally supports TCFD disclosures and issued its first TCFD report for 2020 to provide an overview of its current achievements and further actions to integrate climate-related risks and opportunities into the core of its business. See EIB Group, Task Force on Climate-related Financial Disclosures (TCFD) Report 2020 (2021).

[25] FSB, Report on Promoting Climate-Related Disclosures (2021), p.10.

emissions, including under insurance contracts, credit guarantees, financial guarantees, export credit insurance and credit default swaps, accounting currently remains optional under the GHG Protocol. See World Resources Institute & World Business Council for Sustainable Development (2013), Technical Guidance for Calculating Scope 3 Emissions, category 15, pp. 137-139.

Work on insured emissions as a form of financed emissions is underway. In October 2021, the Partnership for Carbon Accounting Financials (PCAF), in collaboration with the UN-convened Net-Zero Insurance Alliance, launched the PCAF Insured Emissions Working Group. It will develop a global, standardised methodology to measure and disclose the GHG emissions of insurance and reinsurance underwriting portfolios. The work will help re/insurers "understand the climate impact of their underwriting decisions, laying the foundation to decarbonise their insurance and reinsurance portfolios through target setting, scenario analysis, strategy development, and individually taking concrete actions that have real-world impact through emissions reduction in the real economy". See UNEP FI, "Partnership for Carbon Accounting Financials Collaborates with UN-Convened Net-Zero Insurance Alliance to Develop Standard to Measure Insured Emissions" (6 Sept. 2021).

2.2. From Disclosure to Net Zero commitments by financial actors

22. The initial focus of the TCFD was on evaluation and disclosure of climate risks. Recently, better disclosure and a heightened sense of urgency have led to growing public and private sector commitments to net zero and Paris alignment, as noted by Mark Carney, former governor of the Bank of England and chair of the FSB:

> *Since Paris, the concepts of Net Zero, Paris Aligned, and a 1.5 degree target have moved from the climate cognoscenti into the mainstream. Net zero is now an organizing principle that is cascading from the global to the country and the company … The combination of forward-looking climate disclosure, net zero plans, and portfolio alignment metrics will pull forward investment, especially if there are credible and predictable climate policies from governments.*[26]

Government net zero commitments have advanced from 30% of emissions in 2019 to over 85% percent today.[27]

[26] Mark Carney, Clean and Green Finance: A new sustainable financial system can secure a net zero future for the world, Finance and Development (IMF) (Sept. 2021).

[27] See Netzero Tracker.

23. For financial actors, portfolio alignment with the Paris Agreement and with net zero can be taken to refer to "the action of assessing the net-zero transition progress of the individual counterparties that make up a given financial portfolio, and determining whether or not, at an aggregate level, that group of counterparties are collectively Paris-aligned. … Achieving and maintaining portfolio alignment is necessary for a financial institution to be compliant with the goals of the Paris Agreement."[28]

24. Forward-looking metrics are being developed. In October 2021, the TCFD highlighted its development of "new guidance for companies to disclose their plans for a net zero transition in line with the Paris Agreement ….".[29] The recent proposed SEC rule would require listed companies that have publicly set climate-related targets or goals to provide information about, *inter alia*, the nature of the target, how the company intends to meet it and relevant data on progress each year.[30]

25. At COP26, the members and observers of the inter-governmental International Platform on Sustainable Finance[31] committed to cooperation on approaches and tools "to identify, verify and align investments with sustainability goals, including definitions and taxonomies, taking due account of local specificities and transition considerations".[32] In Feb. 2022, the Platform established a working group to "explore how sustainable finance alignment approaches such as taxonomies, labels and portfolio alignment metrics, as well as corporate strategy and disclosures may integrate transition considerations".[33]

26. The Glasgow Financial Alliance for Net Zero (GFANZ) is a global coalition of leading financial institutions. It is focused on broadening, deepening and raising net-zero ambitions across the financial system and demonstrating firms' collective commitments to supporting companies and countries to achieve the goals of the Paris Agreement. It also supports collaboration on steps firms need to take to align with a net-zero future. Launched in April 2021, its members currently include over 450 financial firms across 45 countries responsible for assets of over $130 trillion.[34]

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28 See Portfolio Alignment Team, Measuring Portfolio Alignment: Technical Considerations (2021), p. 79. See also The Economist, The truth about dirty assets: Polluting businesses are moving into the financial shadows (12 Feb. 2022) ("If institutional investors are serious about being green, they should consider the entire carbon footprint of their portfolios.")

29 See TCFD, Fourth TCFD Status Report Highlights Greatest Progress to Date on TCFD Adoption (14 Oct. 2021).

30 US Securities and Exchange Commission. Enhancement and Standardization of Climate-Related Disclosures, Fact Sheet (2022).

31 The International Platform on Sustainable Finance is a forum for dialogue between policymakers, launched in 2019 by the EU, with the overall aim of increasing the amount of private capital being invested in environmentally sustainable investments. Together, its 18 members represent 55% of greenhouse gas emissions, 50% of the world population and 55% of global GDP.

32 See International Platform on Sustainable Finance: committing towards international cooperation in the development of sustainability alignment approaches and tools (Nov. 2021).

33 See Gina Gambetta, "Switzerland, EU and Japan to co-lead International Platform on Sustainable Finance working group", Responsible Investor (28 Feb. 2022).

34 See Glasgow Financial Alliance for Net Zero (GFANZ).

27. In the insurance field, UN Secretary General António Guterres has insisted on the need for net zero alignment of insurance portfolios: "We need net zero commitments to cover your underwriting portfolios, and this should include the underwriting of coal -- and all fossil fuels."[35] Members of the Net-Zero Insurance Alliance, launched in mid-2021, have committed to transition their respective insurance and reinsurance underwriting portfolios to net zero and to set science-based targets every five years.[36]

28. Public sector actors such as ECAs have recognised their responsibility for financed and insured emissions as part of their scope 3 emissions. For example, UK Export Finance recognises that "[UKEF's] biggest greenhouse gas emissions impact is from our scope 3 emissions, which are the emissions produced from the support we provide through our lending, guarantees and insurance products. We collectively refer to these as our portfolio emissions."[37] In carrying out its commitment to net zero by 2050 across its portfolio and operations, UKEF expects to, *inter alia*, reduce its exposure to high greenhouse gas emitting sectors, support more business in low or no carbon sectors, and ensure that GHG emissions from its support are minimised.[38]

29. The Board of the public sector European Investment Bank (EIB) decided in 2019 to ensure that "all financing activities are aligned to the goals and principles of the Paris Agreement by the end of 2020". It has underlined that the EIB Group "cannot support the [Paris] Agreement with 50% of green finance if, at the same time, it undermines the goals with the remaining 50%. In line with the principles of sustainable finance, the EIB Group needs to ensure that all its activities do no significant harm to the low-carbon and climate-resilient goals of the Agreement".[39] The EIB Group provides a wide variety of financial services including loans, guarantees and equity investments. It will first develop an approach in the context of new projects and then generalise it across all EIB Group operations.[40]

30. These efforts to align finance with net zero and the Paris Agreement target the climate alignment of counterparties in portfolios – encouraging the green transition by business. They are unconnected to government policy space for regulatory action.

[35] António Guterres, Closing remarks to 2021 Insurance Development Forum (July 2021).

[36] The Net-Zero Insurance Alliance is a group of over 20 leading insurers representing more than 11% of world premium volume globally.

[37] UK Export Finance, Climate Change Strategy 2021-2024 (2021) p. 14.

[38] Id.

[39] EIB Group Climate Bank Roadmap 2021-2025 (2020), para. 7.

[40] Id. para. 25.

Box 2. Practical steps in getting to Paris and Net Zero alignment – the Race to Zero Starting Line Criteria

Steps to alignment with Net Zero have been developed and set out by a range of organisations. The four steps in the UN Race to Zero "starting line" criteria provide one recent and widely used guide to the initial steps in making and carrying out a net zero commitment.

Pledge: Pledge at the head-of-organization level to reach (net) zero GHGs as soon as possible, and by midcentury at the latest, in line with global efforts to limit warming to 1.5C. Set an interim target to achieve in the next decade, which reflects maximum effort toward or beyond a fair share of the 50% global reduction in CO2 by 2030 identified in the IPCC Special Report on Global Warming of 1.5C.

Plan: Within 12 months of joining, explain what actions will be taken toward achieving both interim and longer-term pledges, especially in the short- to medium-term.

Proceed: Take immediate action toward achieving (net) zero, consistent with delivering interim targets specified.

Publish: Commit to report publicly both progress against interim and long-term targets, as well as the actions being taken, at least annually. To the extent possible, report via platforms that feed into the UNFCCC Global Climate Action Portal.

Source: Race to Zero, Starting Line and Leadership Practices 2.0, https://racetozero.unfccc.int/wp-content/uploads/2021/04/Race-to-Zero-Criteria-2.0.pdf

3. Investment treaties and the Paris alignment of finance flows

3.1. Investment treaties and finance flows

31. Investment treaties are an important part of the public policy framework governing finance flows. The treaties directly address and seek to promote finance flows and treaty-covered investors (counterparties) are frequently financial investors. Shareholders are covered by investment treaties and lenders are often covered as well. More broadly, international transfers of capital are the trigger for application of investment treaty provisions. All such transfers involve finance flows. While the actual economic effects of

investment treaties can be hard to determine, major companies regularly contend that the system reduces political risk for them and encourages investment covered by the insurance effects of treaty protection.[41] Companies and lawyers on their behalf also engage in corporate structuring to seek to obtain coverage under investment treaties for their finance flows.[42]

32. The finance flows at issue in the current investment treaty system frequently extend to essentially the full range of investment broadly construed and therefore can easily be associated with high-carbon activities among others. For example, over 100 ISDS cases and seven of the top ten USD 1 billion-plus damages awards involve fossil fuel interests.[43] While there have been few government policies creating stranded fossil fuel assets to date, some of the first non-discriminatory OECD government policies directed at gradual exits from coal have generated major claims in ISDS[44] or multi-billion euro payments reportedly in part in exchange for release of ISDS claims.[45]

33. The concept of insured emissions in work on finance flows and climate may be of particular relevance to investment policy makers because treaty-based investment protection is frequently seen as functionally equivalent to political risk insurance.[46] As a conceptual matter, financial payments by governments pursuant to investment treaties are made to individual institutional units exposed to certain risks upon the occurrence of specified events. This closely follows the OECD Glossary of Statistical Terms defining insurance as an activity "intended to provide individual institutional units exposed to certain risks with financial protection against the consequences of the occurrence of specified events".[47]

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41 See, e.g., 2020 QMUL-CCIAG Survey: Investors' Perceptions of ISDS (survey conducted by the School of International Arbitration, Centre for Commercial Law Studies, Queen Mary University of London (QMUL) with the support of the Corporate Counsel International Arbitration Group (CCIAG)). Respondents from companies said the availability of treaty-based protections for investors, the availability of ISDS and the host state's history of involvement in investor-state disputes all "strongly influence" their investment decisions". Id. at p. 8.

42 The impact of ISDS on finance flows has also become intense. Financial investors such as shareholders are routinely found among ISDS claimants. ISDS has the highest average claim for payment and highest average binding award requiring payment of any legal system in the world, which has attracted growing interest from a range of financial actors. Institutional investors and third-party funders finance ISDS claims, including fossil fuel claims, in exchange for part of any payments received on the claim that a risk has occurred. Funders use the capital markets to raise money to fund ISDS claims, resell parts of interests in funded ISDS claims to other funders and "monetise" claims for large amounts – converting a portion of a pending claim into immediate cash. They increasingly deal in portfolios of claims.

43 See UNCTAD, Investment Dispute Settlement Navigator.

44 Stuart Braun, Multi-billion euro lawsuits derail climate action, Deutsche Welle (19 April 2021).

45 Reuters, German government approves lignite compensation contract (16 Dec. 2020).

46 See, e.g., Olga Boltenko and Nanxi Ding, Risky business: political risk insurance in the OBOR jurisdictions – Report on the 4th CMS-HKIAC Investment Law Lecture (29 July 2017) ("Traditionally, the investment community views recourse to investment arbitration itself as a form of insurance against political risks"); Ian Roberts and Vanessa Kilner, Political Risk Insurance vs Bilateral Investment Treaties, Asia Insurance Review (April 2014) ("both BITs and [political risk insurance] provide foreign investors legal protection against the occurrence of political risks").

47 See OECD Glossary of Statistical Terms – Insurance. Except for expropriation, the text of many investment treaties does not explicitly mandate an insurance model. Consequences of the

34. While the basic principles appear to be essentially similar, there are differences between treaty-based insurance and typical contract-based insurance. But none would appear to affect the now increasingly-recognised basic principles of climate responsibility of financial actors with regard to finance flows.

35. Some features of investment treaties are more powerful for counterparties than commercial or ECA insurance. Treaties typically cover a broad range of risks such as “arbitrary” government action or a government failure to provide “fair and equitable treatment”, whereas coverage under commercial or ECA political risk insurance (PRI) is typically limited to more specific risks such as expropriation, currency inconvertibility or political violence.[48] Risks such as a failure to provide fair and equitable treatment are generally seen as too vague or broad for commercial or ECA coverage.[49]

36. Investment treaties can give rise to very large payments. They are generally interpreted to provide uncapped compensation including future lost profits if established. Commercial or ECA insurance typically has specified maximum coverage amounts. Coverage can be limited to book value and often requires a co-payment from insured entities when risks occur.

37. However, other features of investment treaties may be less attractive to counterparties: a greater need for lengthy litigation (albeit frequently for vaguely defined risks normally beyond the scope of commercial or ECA PRI); and less certainty of payment or its timing in some cases. While investment treaties generally cover the risks covered by commercial and ECA PRI, in some cases, commercial or ECA insurance may cover risks not covered by some investment treaties.

3.2. Investment treaties: towards commitments and action on Paris Agreement alignment?

38. In contrast to some other insurers and financial actors, there has been limited evidence of consideration by governments of TCFD, Paris or net zero alignment of their investment treaty portfolios of counterparties. Government commitments to end support for fossil fuels abroad or for coal abroad, as noted above, invite consideration of their application to investment treaty support in those sectors.[50]

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occurrence of the risk are often undefined. However, arbitral interpretation routinely provides for financial payments. Some recent investment treaties move away from an insurance model by expressly providing primarily for state-to-state dispute settlement or non-pecuniary/negotiated remedies.

48 See, e.g., Rishab Gupta and Niyati Gandhi, The Investment Arbitration Review: Political Risk Insurance (June 2021) (“Like PRI policies, most IIAs protect investors against expropriation, currency inconvertibility and political violence, but the scope of the protection provided under IIAs is often wider.”)

49 Id. (“A valuable guarantee available under IIAs, which is not found in any PRI policies, is the host state's promise to treat foreign investment in a 'fair and equitable manner'…. PRI is not available for breaches of the FET standard. That makes commercial sense. An insurance provider would not want to put in its policy vague standards of international protection, which are subject to substantive interpretative ambiguity.”).

50 As outlined above, finance flow alignment is generally seen to require short term action on obvious high carbon activities. However, it also involves a more detailed and ongoing process of transitioning broader portfolios. See Box 1, supra.

39. Consideration of net zero may be timely because other public sector financial actors that provide insurance services are seeking to align with the Paris Agreement and net zero. Following criticism from parliaments, business organisations, academics and NGOs[51], a broad range of national export credit agencies (ECAs) are committing to end support for certain projects involving coal, to apply the TCFD framework to their portfolios or to achieve net zero.[52]

40. Recent editorials and articles in the business press may also suggest that consideration of net zero may be overdue, as they explicitly call for a rethink of investment protection treaty policies seen as interfering with the alignment of finance flows with climate goals:

> *The prospect of "bailing out" fossil fuel projects risks disincentivising the steps needed now, from both markets and government, to secure swift decarbonisation. … As figures from Mark Carney to John Kerry have made clear, any hope that we have of transitioning away from carbon at the necessary pace will rely on private markets. Capital must be allocated quickly towards renewables. … [G]overnments will confuse things if they pay up in a way that means fossil fuels cannot lose. While renewables will remain the safe play long-term, the pace of capital's shift away from fossil fuels may decrease.*[53]

41. The Group of Thirty has underlined the benefits of credible government climate policies and immediate action:

> *First, a credible policy framework ensures that financial markets anticipate future policies and the economy starts adjusting to them today. Starting to cut emissions to net zero one year earlier can significantly reduce the ultimate end-point carbon concentrations. … Second, credible policy frameworks reduce the risk of adding to the existing stock of "stranded assets." Credible policy frameworks reduce the risk that businesses form wrong expectations about future policies and continue to invest in obsolete technologies. … Third, if policy is*

51 See, e.g., Environmental Audit Committee report on UK Export Finance (June 2019) (finding that UKEF's activities are the 'elephant in the room' undermining the UK's international climate and development targets, with unacceptably high support for fossil fuel projects in low and middle-income countries that risks locking them into high-carbon dependency for decades to come; UKEF should develop net zero plan); ICC, Sustainability in Export Finance (2021), p. 28 (while financial services industry has taken important steps to support the transition towards a low-carbon economy, "[s]ince 2015, ECAs' activities appear to have generally been omitted from the greenhouse gas mission reduction targets and commitments of countries"); Thomas Hale et al, Towards Net Zero Export Credit (2021), Igor Shishlov et al., Aligning Export Credit Agencies with the Paris Agreement (2021); Oil Change International and Friends of the Earth, Adding Fuel to the Fire: Export Credit Agencies and Fossil Fuel Finance (2020).

52 OECD, Agreement reached at OECD to end export credit support for unabated coal-fired power plants (Oct. 2021); Export Development Canada Commits to Net Zero by 2050 (July 2021); UKEF commits to going carbon neutral by 2050 ahead of COP26 (Sept. 2021); Export Finance for Future (E3F) (April 2021) (7 European countries commit inter alia to ending trade and export support directed to unabated coal power, and assessing how best to phase out support for fossil fuels); Astrid Brunswijk et al, Working towards a commitment to net zero, Berne Union Yearbook (2020), pp. 153-157; Jessica C. Liao, The Club-based Climate Regime and OECD Negotiations on Restricting Coal-fired Power Export Finance, Global Policy Vol. 12-1 (Feb. 2021).

53 Financial Times editorial board, Governments should not foot the bill for stranded assets: Treaties that lead to fossil fuel bailouts need a rethink (21 Feb. 2022).

> *viewed as credible, policymakers need to intervene less forcefully to achieve a given climate target. If ambitious climate targets are seen as credible, businesses will stop investing in high-carbon technologies and in the future, there will be fewer fully depreciated carbon-intensive plants competing against green alternatives.*[54]

Mark Carney has similarly underlined that "[f]inancial firms can't deliver sustainable economies alone — clear, credible, and ambitious climate policies are needed from G20 governments".[55]

42. Public and private financial actors committed to Paris Agreement alignment of finance flows are engaged in intensive efforts to address a range of conceptual and operational issues necessary to achieve progress on alignment. The issues vary for different actors, but joint action and commitment to achieve results can be key to overcoming difficulties. Visible action in particular policy fields can also bolster the credibility of government climate commitments.

Issues for discussion

- Should governments commit to Paris and net zero alignment of their investment treaties? Is the absence of climate quality criteria or underwriting a necessary component of investment treaty policies?

- What lessons can investment treaty policy makers draw from the net zero alignment activities of other actors with influence on finance flows?

- What steps would be needed for better or complete Paris and net zero alignment of investment treaties in the short term and medium term?

[54] Group of Thirty, Mainstreaming the Transition to a Net Zero Economy (2020), pp. 15-16 (footnote omitted).

[55] See Owen Walker & Stephen Morris, Big banks resist most direct road map to net zero emissions, Financial Times (11 Oct. 2021).

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