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COP26: NATURE-BASED SOLUTIONS TO CLIMATE CHANGE

— THOUGHT LEADERSHIP

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COP26 – the United Nations' 26th conference on climate change is expected to focus not only on the global climate crisis, but also to highlight the interconnected loss of biodiversity. These issues will have a huge impact on all of us – including businesses. At a recent Clifford Chance event, a panel of experts discussed nature-based solutions and the crucial role nature plays in combating climate change and sustaining national economies, as well as examining how state and private sector nature-based solutions could be financed.

The Dasgupta Review, an independent global review on the Economics of Biodiversity, commissioned by the UK Treasury, says that fundamental change is needed to the way in which we think about economics and biodiversity if we are to protect our prosperity. It says significant declines in biodiversity are putting our economies and livelihoods at risk and that we must transform our institutions and systems – particularly finance and education, by increasing public and private financial flows that enhance our natural assets and reduce those that degrade them – and by empowering citizens to make informed choices and demand change.

"The depth of international consensus on tackling climate change has accelerated since the Paris Agreement in 2015, but even more so over this past year or so, as we've seen China and the US, in particular, really picking up the pace," says Roger Leese, a Clifford Chance Partner and Co-Head of the Global Business and Human Rights practice. "COP26 could lead to significant advances in the international consensus and significant commitments to action by the world's governments, all of which is highly significant to businesses across all sectors and regions."

The interconnection of climate and biodiversity

The focus of COP26 has shifted in recent weeks and, while there is no longer a Nature "theme" for the conference, nature-based solutions are amongst the goals of COP26 including curtailing deforestation, protecting and restoring ecosystems (with developed countries providing at least US$100 billion per year in finance to deal with these issues), and creating a robust system of carbon credits.

"Nature plays an important role in tackling the climate crisis," says Martin Berg, head of natural capital impact strategy at HSBC Pollination, Climate Asset Management, and a guest speaker at Clifford Chance's COP26 event. "We are taking the value of nature for our well-being and for the economy for granted, and are losing biodiversity at an unprecedented level. While the focus is currently on climate change, biodiversity will become a policy issue."

Clifford Chance Partner Deborah Zandstra, who works in the capital markets practice, says that biodiversity loss is not just an issue for governments: "Policymakers, industry and finance really need to turn their focus as to what can be done to address biodiversity loss, because it will have a devastating impact."

Whilst there are potential technology-based carbon capture solutions – for example, carbon capture and storage in oil wells beneath the North Sea – there are also nature-based solutions for storing carbon. These include forests, woodlands and peat lands, and kelp forests in the oceans. "Blue carbon" also plays a vital role. The oceans are the world's largest store of carbon, where an estimated 83% of the global carbon cycle is circulated through marine waters.

"Well-functioning ecosystems with all the key species present will fulfil carbon sequestration much better than degraded systems and that's for me why the global reduction in biodiversity and the climate crisis are so intimately linked," says another guest speaker, Robert Spencer, Business Line Director for ESG at infrastructure consultancy, AECOM.

Defining and measuring nature-based solutions

The definitions of nature-based solutions are very broad. The British Ecological Society recently produced a report on nature-based solutions, defining them as solutions that deliver benefits for biodiversity, climate change mitigation and climate change adaptation. Robert Spencer says that "green infrastructure" can help create more resilient places for humans and nature to interact, but they also mitigate climate change by locking in carbon. Practical examples include creating reed beds at water treatment plants, where any contamination is "sucked up" by the reeds, and encouraging sheep farmers to plant more trees to prevent heavy rains eroding hillsides. Martin Berg adds that nature-based solutions also work very effectively in cities. "Athens, for example, received a European Investment Bank loan to create green spaces for resilience and cooling, which was highly cost-effective. Engineers will always tell you that you need to build something, but very often you can achieve the same results with nature-based solutions at lower costs and often with additional benefits."

However, for nature-based solutions to make a significant impact, their effectiveness needs to be measured, says Robert Spencer: "We need to be able to count, visualise, and explain nature-based solutions in financial terms. We've seen some shifts in terms of practice, academic rigour and scientific references for how to quantify the benefits we get from nature from things such as air and water quality, flood alleviation, pollination, sound and noise, cooling, warming, and the attributes that we obtain from well-functioning ecosystems. Monetising, and being able to present the capabilities of natural systems in a way that financiers, accountants and e-commerce specialists can understand and integrate into their normal planning and systems, is crucial."

Data is therefore crucial. Gathering information on the ground from ecologists and environmental economists is labour-intensive and time-consuming, but the digitisation of environmental assessment is speeding up the process. "Technology is helping us understand and calibrate the state of natural systems remotely, using satellite data, and integrating that into geographical information systems to enable the identification and verification of any improvements that are taking place," Spencer says. "AI and machine learning are also enabling us to calculate how nature-based solutions are working."

Assessing the risks

Deborah Zandstra says that financial institutions, for example, need to employ ecologists, nature specialists and biodiversity experts who can assess the risks of a loss of biodiversity "and help to monetise and create innovative finances and structures that investors can really understand."

Historically, family offices have been very active in investing in nature-related projects and have often used "lender finance" – they look for private or for public donors to provide some loss protection or some technical assistance in order to make projects viable. "Many of these investments have been very small, but interest is rising and we are seeing more investors coming through," says Martin Berg. He adds that climate-related financial disclosures are driving many large institutions to assess their portfolios. The Taskforce on Nature-related Financial Disclosures (TNFD), a new global initiative which aims to give financial institutions and companies a complete picture of their environmental risks, received the backing of the G7 at its recent summit, and its wider adoption is likely to encourage more investors to examine the risks they face. "I think investors will look

first at the risk and ask where am I exposed in my supply chain and my portfolio? Where are the hidden risks? Once that data is available and the picture becomes very clear, then they will focus on opportunities."

Blue bonds and debt-for-nature swaps

"Blue bonds – which specifically focus on ocean projects – have not received the attention they deserve," says Deborah Zandstra. "This is reflected in part by the fact the International Capital Market Association (ICMA) does not have Blue Bond Principles, albeit there are some water categories in the Green Bond Principles. But blue bonds should for the most part sit squarely in the nature-based solutions box." She adds that the Firm is getting a lot of enquiries about blue bonds since working on the 2018 Seychelles Blue Bond, which raised US$15 million to support the expansion of marine protected areas, improved governance of priority fisheries and the development of the Seychelles blue economy. The deal was small in size, but had a big impact. It benefited from a World Bank guarantee and a concessional loan from the Global Environmental Facility, and was privately placed. "Other small island nations would benefit greatly from such transactions, but there is the issue of pricing and scalability and some templating/pooling of deals could be considered. Especially now, with debt challenges, incurring new debt and increasing debt to GDP levels means it is not so attractive to some countries," she says.

Alternatives such as debt-for-nature swaps are being explored. These are transactions which relieve a portion of a developing country's debt in exchange for local investment into environmental and conservation projects. The purchase of existing debt is a key component, as that debt relief releases payment capacity to be redirected to pursue the conservation milestones. The outcome should be that the debt servicing costs of the new composite arrangement used to finance the purchase is lower than the contractual debt servicing costs of the foreign currency debt which is purchased and extinguished. Clearly, the discount from face value applicable to the foreign currency debt which is purchased is a relevant factor and this can present an additional challenge in such transactions. But where a country has, for example, Paris Club debt, or private sector creditors who would be able to support such a transaction and potentially some additional donor or risk mitigation support, debt-for-nature swaps are worth exploring. "As we move into an understanding that nature should be seen as an asset, it should also be possible to monetise its ability to generate value, including through income generation or carbon offsets," says Zandstra.

Private investment in nature-based solutions

With the Biden Administration rejoining the Paris Agreement and recently announcing that it would by 2030 cut emissions by half, greater attention is being paid to nature-based solutions in the US. "We are expecting to see a pretty significant growth of public spending in green initiatives and mobilisation of private investment in the green economy," says Dan Drabkin, a New York-based Partner specialising in funds and investment management. "What is interesting in President Biden's latest proposal is that it specifically mentions nature-based solutions and carbon sinks. We are definitely seeing greater public recognition of the role of nature-based solutions, and US corporate entities and financial institutions focusing on ESG and the fight against climate change, which is a step in the
right direction."

He adds that larger asset management firms are beginning to be active in this space and on a much larger scale, using ways to blend private and public capital. "Specifically, we've seen some funds that are focused on regenerative agriculture, sustainable forestry, some marine projects and fisheries. It's a question of whether or not you can put it into a model that's for profit."

In Europe, a driver in the funds arena is the EU disclosure regulation. "This will require managers that are caught by those regulations to determine whether they classify their products and say whether they are a non-ESG product, a product that promotes environmental social characteristics, or the darkest green category, which is a product that invests in sustainable investments," says Lily Marcel, a Senior Associate in Clifford Chance's London Private Funds.

She adds that the introduction of the EU Taxonomy Regulation, which sets out categories of economic activities that are considered environmentally sustainable, "means more asset managers are focusing on how to launch products that can be sold as taxonomy aligned."

Corporations, entities and organisations that are dependent on nature-based solutions to function – such as water utilities – are at the forefront of integrating natural capital accounting into their asset portfolio investment and management cycles.

What can COP26 achieve on investment in nature-based solutions?

"The starting point is who is it that's going to pay?" says Roger Leese. "To date, there have been a number of successful nature-based projects, but money has essentially come largely from philanthropic NGO sources, or in some cases from governments. How you also tap into private finance is something that we're all grappling with." He adds that one of the biggest experiments in this area is the UK's switch from the common agricultural policy to the Environmental Land Management scheme (ELMs), through which land owners will be paid for preventing floods, planting woods and protecting wildlife. As well as drastically changing the public subsidy regime, this could make restoration programmes an investible asset for private investment.

Developed nations also aim to make US$100 billion dollars a year available. "How that is spent is key – some of that could be debt relief-related, but some could be directly employed in nature-based solutions such as protecting or creating forests in other countries, but the extent to which any of this will be used to catalyse private for-profit investment remains to be seen," says Leese.

Developing carbon markets is another key ingredient. " Finding a solution on carbon markets, by creating a robust system of carbon credits that supports the move to net zero is an explicit goal for COP26, which is right, but a properly functioning carbon market has to build in biodiversity because there have been issues in the past with the carbon market that incentivised bad behaviour, leading to biodiversity loss," says Leese.

Martin adds: "We should not forget that carbon is probably the most obvious impact that can be measured, but which can also monetised. At COP26, the discussions on Article 6 of the Paris Agreement (covering rules for carbon markets), will be important because currently there is no incentivisation to stop deforestation. The recognition that nature can play a role could act as an incentive." He adds that many corporates have set ambitious targets and that nature-based solutions are a good way of helping them to achieve those targets.

It's clear that for there to be real progress, private sector funding will be needed. "In future, blended finance and innovative transactions with credit enhancements and other sorts of partial credit guarantees will buttress the market, but it really needs banks and others to make someone within an organisation responsible for investment and transaction execution in this space," says Zandstra, adding: "I think multilaterals need to expand their ESG standards to include biodiversity, as well to support some of the activity in the regulatory space."

Many large infrastructure organisations in the UK are committing to either no net loss of biodiversity or biodiversity net gain. "Increasingly, large schemes, such as new roads, railways and tunnels, are under a lot more scrutiny. It is easy for stakeholders and activists to access vital information around projects, so large infrastructure schemes need to be transparent about how they are approaching some of these hot topics around climate and biodiversity," says Robert.

What is happening with COP15?

COP26 is not the only summit planned for this Autumn – COP15 is the UN Convention on Biological Diversity, which is due to take place in China in October. The G7 has put biodiversity at the top of its agenda and says that COP15 will be a key event. However, unlike tackling climate change, there is no one clear action to deal with the reduction in biodiversity. "I think we will see some progress. With climate change, we know what we have to do to deal with the climate emergency, the question now is what do we do about biodiversity?" says Martin.

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