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Note: This individual submission from Ecojustice focuses on the most recent academic knowledge in this field and on providing sources for statements in Karine Péloffy's testimony. The detailed recommendations stemming from these conclusions are part of the collective submission shared with the committee by Environmental Defence Canada.

The unresolvable puzzle of the materiality of climate-related risks

British economist Sir Nicolas Stern was calling climate change the biggest market failure the world has ever seen in the landmark 2007 report titled *The Economics of Climate Change*.[1]

Almost 20 years later, despite all the grandstanding and noise, we have not addressed this great market failure that is climate change. Large Canadian financial institutions still operate - for the most part - as if the climate crisis did not exist, and as if government efforts to curb carbon emissions do not concern them.

Worse, Canadian banks are some of the largest investors in fossil fuel expansion[2], and undermining their own net zero commitments.[3] That is, they fund the very cause of the climate crisis, even as the governments of the world came together in Dubai last year and finally agreed to name the climate culprit and pledged to "transition away from fossil fuels."[4] This is a clear signal that financing fossil fuels is unsustainable finance.

Much of the conversation on how finance apprehends climate change focuses on disclosure of material risks, mostly the risks that climate change poses to their operations. These risks are clearly on the rise: a recent survey of corporate executives conducted by KPMG found that 56 per cent of surveyed businesses saw profits decline due to wildfires, floods, heat waves and other climate-related damages in 2023.[5] The Insurance Bureau of Canada reported that in the last decade, the annual average of insured losses due to catastrophes was $2.2 billion – more than triple compared to the previous decade.[6] Damage caused by extreme weather events in Canada this past summer cost insurers more than $7.5 billion - a number that the Insurance Bureau of

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[1] Sir Nicholas Stern, *The Economics of Climate Change: The Stern Review* (London: HM Treasury, 2006), accessed online.
[2] Rainforest Action Network et al, *Banking on Climate Chaos: Fossil Fuel Finance Report 2024* (16 May 2024), accessed online (finding that Canada's five biggest banks are among the 20 largest fossil fuel financiers in the world).
[3] FinanceMap, *Canada's Big Five Banks: Heading to Net Zero?* (March 2024), accessed online.
[4] "COP28 Agreement Signals "Beginning of the End" of the Fossil Fuel Era" *UNFCCC* (13 December 2023), accessed online.
[5] "Canadian businesses worry extreme weather will impact profits, KPMG research" *KPMG* (16 July 2024), accessed online.
[6] Nivedita Balu, "Focus: Canada's insurance sector faces climate catastrophe claim deluge" *Reuters* (3 September 2024), accessed online.

Canada called “unprecedented.”[7] These harms will only intensify as the effects of climate change continue to emerge. Scientists and economists predict that by 2035, climate change will amplify global food and headline inflation by 0.92-3.23 and 0.32-1.18 percentage points per-year respectively.[8] Yet, investors somehow manage to interpret risks that are material to everyone to be immaterial to any one actor in particular.

There is some positive movement on transition risks. A 2024 report found that 77 per cent of North America’s largest investors - representing more than half of the global GDP - have made a net zero commitment and have action plans in place to deliver on this commitment.[9] Still, key deficiencies plague investor-led approaches to climate action. Few of the investors studied used climate scenarios as part of strategic investment decision-making. Just 50 per cent of the investors mention plans or strategies to invest in climate solutions.[10] Further, almost 50 per cent of the investors fail to mention any efforts for policy advocacy to combat the climate crisis,[11] while those opposed to acting on the crisis are extremely vocal. Investor-led climate action, alone, is insufficient to decarbonize the global economy.

The one type of climate related risk that goes most ignored is litigation risk. Worryingly, an Oxford study revealed earlier this year that investors are flying blind to risks of climate lawsuits, even as court cases against polluting companies and the financial institutions that support them are mounting globally.[12] Indeed, a survey of central banks revealed that 93 per cent of respondents do not quantify the impacts of climate-related legal risks.[13] By the time these lawsuits get to judgement, which could amount to trillions in liabilities, the risks will have materialized and it will be too late for the prudent risk management that the current rules are meant to ensure.

It is therefore not surprising that a recent survey of approximately 2,000 Chartered Financial Analysts from around the world found that two-thirds believed that climate change-related risks are not sufficiently reflected in current financial market prices.[14]

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[7] Stéphane Bordeleau, “L’été 2024, le plus coûteux de l’histoire pour les assureurs canadiens” *CBC* (24 September 2024), accessed online.
[8] Maximilian Kotz et al, ”Global warming and heat extremes to enhance inflationary pressures” (2024) 5:166 *Communications Earth & Environment.*
[9] “Investor Climate Action Plans are Becoming a Norm” *Ceres* (27 August 2024) at 2, accessed online (pdf).
[10] *Ibid* at 6.
[11] *Ibid* at 3, 5.
[12] Thom Wetzer, Rupert Stuart-Smith, & Arjuna Dibley, “Climate risk assessments must engage with the law” (2024) 383:6679 *Science* 152.
[13] *Ibid* at 153.
[14] Rob Bauer et al, “Mental Models in Financial Markets: How Do Experts Reason About the Pricing of Climate Risk?” *European Corporate Governance Institute*, Finance Working Paper No. 986/2024 (3 June 2024) at 16, accessed online (68% of experts “believe that climate risks are currently not sufficiently reflected in stock prices”).

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Overall, the risk management framework is ill-suited to address the climate crisis: as a former Bank of England economist said: "[j]ust discussing risks, and assessing risks, does not mean we are actually transitioning to net zero. Many firms may discuss risks — and do exactly nothing to advance the transition."[15]

This, we propose, is the result of the existing rules being ill-suited to deal with the climate crisis,[16] and maybe ill-suited period. Even back in 1972, the Journal of Accountancy was lamenting that "[t]he abuse of the concept [materiality] is pervasive as it is all too often cloaks nondisclosure of material financial transactions...there are literally hundreds of public corporate audits taking place each year that contain important accounting transactions that aren't revealed, due to the "Alice in Wonderland" judgment of materiality exercised by a large portion of the accounting fraternity."[17] More recently, Ms. Herren Lee, the former Chair of the Securities and Exchange Commission who first proposed climate specific disclosure rules in the U.S. stated "lawyers, auditors, and managers can and do get the determination of materiality wrong."[18]

Moving beyond a risk management-based framework for addressing climate change

For Canada to deliver on its climate commitments, it must simultaneously attract investment into clean technology and halt the financing of fossil fuel extraction. A risk management approach cannot provide the incentives necessary to divert capital flows away from fossil fuel production and towards greener alternatives.[19]

Widespread financial sector reform is necessary to reduce global consumption of fossil fuels.[20] Our financial system must recognize that supporting fossil fuel use is not a true "transition" to a decarbonized economy. Rather, investing in fossil fuel infrastructure now will "lock-in" use of that infrastructure, even though other, low-emission technologies are available.[21]

Experts at Carbon Tracker recommend that regulators first address the financing of damaging activities and then turn to the more complex regulatory task of promoting greener alternatives. Outcomes from Europe and the UK, where green taxonomies have already been implemented,

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[15] Leslie Hook & Matthew Vincent, "Green business reporting rules at risk of pale response" *Financial Times* (12 November 2020), accessed online.
[16] See generally Canada, Office of the Honourable Rosa Galvez, *Aligning Canadian Finance with Climate Commitments* (Ottawa: Senate of Canada, 2023) at 41 onwards, accessed online.
[17] William Holmes, "Materiality through the Looking Glass" (1972) 133:2 Journal of Accountancy 44 at 44.
[18] Allison Herren Lee, "Living in a Material World: Myths and Misconceptions about "Materiality"" (2021) 35:6 Insights 3 at 6.
[19] Amy Owens, "Where Transition Finance Needs To Go" *Carbon Tracker* (18 June 2024), accessed online.
[20] *Ibid*.
[21] *Ibid*.

show us that taxonomies alone will not divert capital from fossil fuel extraction. Strong financial regulation is required to halt the financing of economic activities that exacerbate climate change.

Indeed,

> "there is less agreement on what counts as 'green' given it is a very new 'sector', but much more agreement on what counts as excessively carbon-intensive (i.e. undesirable) sectors. In other words, climate science clearly says what is undesirable: fossil fuels and in particular coal (Masson-Delmotte et al., 2018); but on the 'green' side there is less consensus and constant evolution with technological and societal changes over time, from renewable sources of energy to nuclear power to negative emission technologies to efficient consumption patterns."[22]

Therefore, we should be very precise in regulating to reduce capital flows to fossil fuels and avoid over-defining and over-regulating green finance. We simply need to provide guardrails for the market in terms of what must be phased out, and let it do what it does best: innovate and allocate capital efficiently.

Conclusion

We cannot afford to wait any longer for the financial industry to realize its error in underestimating climate risks and recognize the fundamental materiality of climate change for all aspects of business decision making.

We do not have effective laws in Canada to compel financial institutions to change tack and to act in coherence with the climate goals we Canadians have taken upon ourselves.

The United Nations Principles for Responsible Investment calls Canada a "low regulation jurisdiction by international standards".[23] This situation must change.

We need a financial sector that supports – rather than works against, as is the case today - Canada's goals to reduce global warming emissions. A financial sector that invests in the solutions to climate change, and that reaps financial benefits while doing so. And in this, we are also dangerously lagging behind our more forward-looking trading partners.

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[22] Hugues Chenet et al, "Finance, climate change and radical uncertainty: Towards a precautionary approach to financial policy" *UCL Institute for Innovation and Public Purpose*, Working Paper 2019-13 (2021) accessed online.

[23] PRI Association, UNEP FI, and the Generation Foundation, "A Legal Framework for Impact: Canada" *UN Principles for Responsible Investment* (February 2023) at 5, accessed online (pdf). See also PRI Association, "Review of Trends in ESG Reporting Requirements for Investors" *UN Principles of Responsible Investing* (2 August 2022) at 10, accessed online.

The time has come to mandate action, and to stop waiting for financial institutions to self-regulate. We need to regulate our way out of unsustainable finance. The *Climate-Aligned Finance Act* is the missing piece we need to align Canada's financial sector with a climate-safe future and to foster a clean investment boom that will future proof our economy.

Ecojustice urges the committee issue a report recommending:

1. **The reform of Canada's financial system to align with climate commitments as provided in Bill S-243, the *Climate-Aligned Finance Act,* which would itself provide a rigorous science-based regulatory framework for annual climate transition planning and reporting and address greenwashing concerns around climate action. (see collective ENGO submission for further details)**

2. **The Office of the Superintendent of Financial Institutions (OSFI) reconsider its interpretation of its mandate, as suggested by the Commissioner of the Environment and Sustainable Development, and to issue detailed guidelines on transition plans.**

3. **Federally regulated public pension managers, in particular the Canada Pension Plan Investment Board and Public Sector Pension Investment Board, be required to fully disclose their investments in private equity funds. (see submission by Shift Action for Pension Wealth and Planet Health for further details)**

4. **A Sustainability Taskforce be established within the Competition Bureau and the rules be strengthened to address greenwashing in the financial sector and to crack down on greenwashing.**