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Paris alignment of operations with financial institutions

AN AFD GROUP PERSPECTIVE ON THE NEED TO RAISE COLLECTIVE AMBITION

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Article 2.1c of the Paris Agreement calls for all financial flows to be consistent with low-carbon and climate-resilient development pathways. This objective reflects the systemic importance of the financial sector to enable the transition to a sustainable future. The concept of alignment with the Paris Agreement (or “Paris Alignment”) aims to advance this objective set by the international community and operationalize it for financial institutions.

A growing proportion of financial institutions are committing to Paris Alignment and Net Zero targets and there are increasing efforts by the financial industry, think tanks and civil society to develop related methodologies and metrics¹. Development Finance Institutions (DFIs), whether multilateral or bilateral², have a key role to play in this widespread effort to reach a low carbon and resilient world. They share with the rest of the financial community the understanding of Paris Alignment as a set of criteria to comply with at the institution and project levels. However, for DFIs, Paris Alignment is also about leveraging their public interest mandates, their diverse financial instruments, and their ability to inform and support policy to maximize climate impacts in the countries and sectors where they operate. Understanding and articulating this dual imperative is critical when thinking about Paris alignment as it relates to DFIs.

This paper is a stocktake of AFD³'s current approach on how we plan to continue improving our practice in operationalizing Paris alignment. **Our stand is that, beyond a project perspective, we need to support our partners - and the systems within which they operate - on their own alignment journey to accelerate the transformation of the financial system and real economy.** Sections 1, 2 and 3 are sector-agnostic, and sections 4 to 8 focus more specifically on operations with financial institutions.

¹ See among others publications by GFANZ, NGFS and SBTi: <https://www.gfanzero.com/publications/> ; <https://www.tcfhub.org/wp-content/uploads/2020/10/PAT-Report-20201109-Final.pdf> and <https://sciencebasedtargets.org/resources/files/SBTi-Finance-Net-Zero-Foundations-paper.pdf>

² For the purposes of this paper, the term « DFIs » will be used to designate multilateral development banks, bilateral development banks such as AFD, and private sector DFIs such as Proparco.

³ For the remainder of the paper, the term « AFD » will be used to designate AFD Group, comprising both AFD and Proparco.

1. INSTITUTION-LEVEL PARIS ALIGNMENT

AFD is an active and supporting member of the Mainstreaming Climate in Financial Institutions initiative⁴, and fully adheres to its five guiding principles, against which it seeks to continuously improve its performance:

- Principle 1: COMMIT to climate strategies
- Principle 2: MANAGE climate risks
- Principle 3: PROMOTE climate smart objectives
- Principle 4: IMPROVE climate performance
- Principle 5: ACCOUNT for your climate action

Furthermore, as a development bank and IDFC member, AFD follows the six IDFC Paris alignment principles, as outlined in the December 2018 IDFC position paper⁵ and further developed by NCI and I4CE in June 2021⁶:

- IDFC principle 1: Increasingly mobilize finance for climate action
- IDFC principle 2: Support country-led climate-related policies
- IDFC principle 3: Catalyse investments and mobilize private capital
- IDFC principle 4: Recognize the importance of adaptation and resilience, especially in most vulnerable countries
- IDFC principle 5: Support the transition from fossil fuels to renewables financing
- IDFC principle 6: Internal transformation of the institution

Further information on the specific objectives embedded in each of these principles, and on their implementation status, can be found in AFD's annual reports, in our 2017-2022 climate strategy⁷, and our 2021 TCFD report⁸.

2. PROJECT-BASED PARIS ALIGNMENT ASSESSMENT

AFD's commitment to being 100% aligned with the Paris Agreement dates back to 2017 and translates in rigorous screening at the individual project level. It has notably led to an increased selectivity materialised in sector strategies and an enhanced exclusion list, in particular with regards

⁴ <https://www.mainstreamingclimate.org/>

⁵ https://www.idfc.org/wp-content/uploads/2018/12/idfc_alignment-with-paris-agreement_position-paper_12_2018.pdf

⁶ https://www.idfc.org/wp-content/uploads/2021/06/report_idfc_frameworkforaligninwiththeparisagreement_final-1.pdf

⁷ <https://www.afd.fr/en/ressources/climate-development-2017-2022-strategy>

⁸ <https://www.afd.fr/en/ressources/afd-group-tcdf-report>

to fossil fuel projects⁹. Direct projects' scope 3 carbon footprints are also systematically measured and any highly emissive projects – defined as above 1Mt CO₂eq/year – are excluded¹⁰.

Further, in order to evaluate the consistency of each operation with the Paris agreement, every project is comprehensively analysed and rated on a scale of -2 to +3 against seven SDG dimensions, two of which are climate related: low-carbon transition (mitigation) and resilience (adaptation)¹¹. The assessment allows for an in-depth context-specific analysis of the projects' consistency with the country's low-carbon development pathway and national adaptation policies. Projects rated -1 or below on either the mitigation or adaptation dimensions are considered misaligned.

3. COUNTERPARTY-LEVEL PARIS ALIGNMENT ASSESSMENT

Contrary to private financial institutions, DFIs typically earmark a significant majority of their loans to specific projects and appraise projects based on a use-of-funds basis. It thus makes sense for them to determine Paris alignment of operations based on individual project assessment as mentioned above. However, there is increasing recognition that this approach can be enhanced and an increasing share of DFIs are looking to assess the Paris alignment of “who” they are financing in addition to “what” they are financing in order to fully comply with Paris Alignment. This is necessary for non-earmarked operations where analysing Paris alignment of counterparties has to be part of the due diligence process to comply with our Alignment commitment. Moreover, there are also some categories of earmarked operations where analysing Paris alignment on a project-basis alone is a challenge, such as operations with financial institutions, dedicated to non-climate related issues (SMEs for example).

Analysing Paris alignment of counterparties, in addition to solely applying a use-of proceeds approach, is also a powerful tool to support the transformation of DFIs' own clients and to generate more impact. Indeed, financing mitigation or adaptation projects is not a sufficient goal in and of itself, even in ever-increasing proportions. DFIs also need to actively contribute to the redirection of financial flows towards low-carbon and resilient investments in the countries they operate in, and to the reduction of the exposure to emissive assets in their clients' balance sheets and overall economy. This means working closely with clients and partners on their overall climate strategies, policies, risk assessments, and business models well beyond the individual project designs. And it requires, as a first step, conducting Paris alignment assessments of clients to determine opportunities and gaps.

⁹ For further details, see AFD's Mid-Term Review of its Energy Transition Strategy :

<https://www.afd.fr/en/ressources/energy-transition-strategy-2019-2022-mid-term-review>

¹⁰ With some rare exceptions being allowed for priority poor countries and projects demonstrated to being compatible with a long-term low carbon pathway.

¹¹ <https://www.afd.fr/en/ressources/sustainable-development-analysis-grids>

4. PRINCIPLES FOR COUNTERPARTY ALIGNMENT ASSESSMENT

Assessing the Paris alignment of a company or financial institution is a new frontier in climate-related methodologies. AFD has concentrated on financial institutions to start with, given their systemic role in the economy and as a contribution to the article 2.1.c Paris Agreement objective. We outline here our current state of thinking and practice on the issue.

AFD takes the view that assessing the Paris alignment of financial institutions should be based on three main principles: it should be performance-based, forward-looking, and context-specific. In so far as it is performance based, the assessment will rely mainly on quantitative information, while the forward-looking component will mainly be based on qualitative information and analysis. These three overarching principles were developed to apply to financial institution analysis, but they should also apply to the analysis of any type of counterparty.

> PRINCIPLE 1: PERFORMANCE-BASED

First, Paris alignment assessment should take into account GHG emissions, which – as far as mitigation is concerned – is what it all comes down to. To rely solely on qualitative information such as strategies and policies is to risk overestimating commitments and undervaluing actual carbon emission trends.

As a proxy for carbon emissions, AFD uses a screening criterion based on the share of fossil fuel sectors¹² in a financial institution's loan book¹³. We also combine this snapshot with a "recent trend" assessment, by looking at how the volume of fossil fuel financing has evolved in the past 5 years.

We are considering extending such criteria to other highly emissive sectors and looking into the feasibility of developing proxies for institution-wide carbon emissions.

> PRINCIPLE 2: FORWARD-LOOKING

While taking a snapshot of a financial institution's loan book exposure to fossil fuels or its emissions profile is a necessary component of a Paris alignment assessment, it says nothing about the future trend, which is where reaching Net Zero will happen. Such forward-looking assessment must look into the financial institution's climate policies, strategy, organization, governance and accountability.

AFD has developed a due diligence questionnaire to carry out such an assessment. The questionnaire aims to provide the information necessary for AFD to analyse the financial institution's practices and procedures for mainstreaming climate issues. It is based on the five Mainstreaming principles mentioned in Section 1 above, and on the recommendations developed by the Task Force on Climate Disclosure (TCFD) on Transition Plans¹⁴. We have also developed and are testing a classification methodology based on the questionnaire's results.

¹² Including upstream, midstream, downstream and power.

¹³ And bond/investment portfolio where applicable, if data is available.

¹⁴ https://assets.bbhub.io/company/sites/60/2021/07/2021-Metrics_Targets_Guidance-1.pdf

> PRINCIPLE 3: CONTEXT-SPECIFIC

Assessing Paris alignment of a financial institution requires taking into account the specific context in which it operates. DFIs work with a wide range of financial institutions, ranging from publicly-listed, continent-size, diversified banks operating in emerging markets to small SME-oriented public development banks in LDCs. Public financial institutions often have specific sectoral mandates (housing, industry, energy, agriculture, municipalities, SMEs...), which determine their emission intensity and limit their reallocation options. The size and internal capabilities of the financial institution should also be factored in. Financial institutions also typically finance the economies they operate in and the country context determines in large part the financial institution's emission profile. Last but not least, the public policy and financial regulatory framework within which it operates also needs to be accounted for, including as actionable levers.

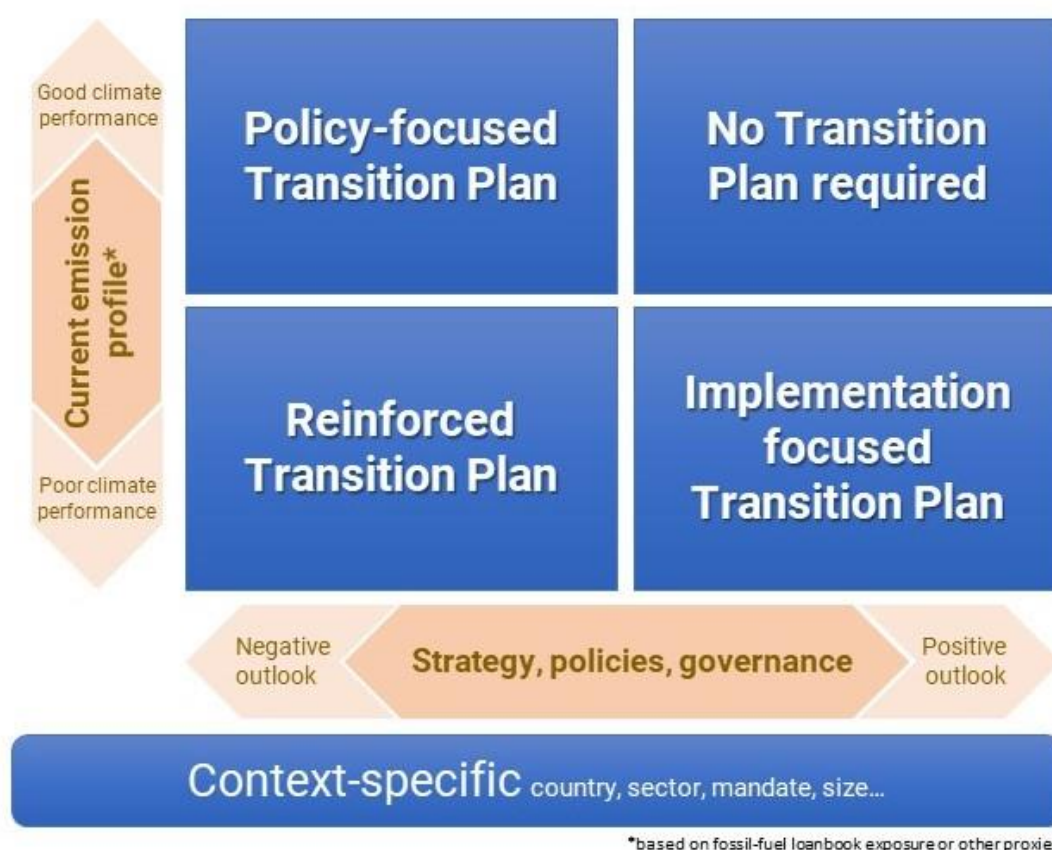
5. PROVIDING SUPPORT TO CLIENTS AND PARTNERS AND LOOKING FOR IMPACT

AFD is committed to supporting its clients and partners in the development and implementation of their low-carbon and resilient strategies. Once a Paris alignment assessment has been carried out, AFD can support a financial institution in elaborating and implementing a Transition Plan, i.e. an institution-wide roadmap including short-, medium- and long-term objectives and corresponding actions. The Transition Plan's ambition level should depend on the initial Paris alignment assessment. Such Transition Plans must be tailor-made and factor in the financial institution's strengths and weaknesses as well as the specific context it operates in. Its implementation should be adequately phased in time and supported with the appropriate technical support.

“Transition Plans should not concentrate exclusively on the mitigation of climate related risks or misalignment risks but also include climate opportunities and impact.”

Transition Plans should not concentrate exclusively on the mitigation of climate related risks or misalignment risks but also include climate opportunities and impact. In the case of public development banks with sector-specific mandates, concentrating on mainstreaming climate in operations, developing green products and working with clients to minimize climate risks and seek opportunities, might be the main avenue – and sometimes only option available – to contribute to greening the economy. A diversified financial institution might be in a position to work comprehensively with its emissive clients on transition pathways, to diversify its portfolio to promote non-emissive sectors or even to divest.

Figure 1. Transition Plan requirements as a function of Paris alignment assessments (indicative)



Source AFD

6. LOOKING FOR SYSTEM-WIDE IMPACTS

One of the main difficulties when engaging with client financial institutions on Paris alignment – or even on climate related financial risk – is the absence or paucity of regulatory and economic incentives for them to engage in institution-wide transformations. It is thus essential for DFIs to work with governments, finance ministries, central banks and regulators, through technical assistance and policy-based lending, to support the development of incentive structures and regulatory frameworks compatible with a low-carbon and resilient financial system. Such policy developments include green taxonomies, banking supervision initiatives on climate-related financial risks, green prudential provisions, fiscal incentives on green financial products, etc¹⁵, and can be envisaged at national, regional and/or international levels.

Contributing to system changes is a way for DFIs to both support partner financial institutions in the steps they are taking to mainstream climate considerations in their activities, and more generally, to

¹⁵ System wide policy support is a key component of AFD's Financial System Strategy:
<https://www.afd.fr/en/ressources/financial-systems-2018-2022-strategy-summary-midterm-review>

have a significant impact on mitigation and adaptation pathways in the countries they operate in. Such activities need to be carried out in synergy with the Transition Plans mentioned above.

7. IMPLEMENTATION OF THE PARIS ALIGNMENT FRAMEWORK TO DATE

At AFD, Paris Alignment of operations with financial intermediaries is appraised by looking at Paris alignment of the underlying use of proceeds using rigorous screening criteria. For non-earmarked operations we have defined minimum performance-based quantitative criteria, based on fossil fuel loan-book exposure as mentioned in section 4. We have also developed a "Pro-Climate" approach to support financial institutions transformation and reinforcement of their strategic and operational framework in order to better integrate climate change, using assessments at the counterparty/borrower level, as described in sections 4 and 5 above. These strategic assessments and support modalities are currently rolled out only in conjunction with non-earmarked operations.

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AFD is in the process of further improving this Paris Alignment framework for operations with financial institutions, comprising both intervention criteria for earmarked and non-earmarked operations and strategic Pro-climate approaches. The objective is to continue raising our ambition and maximising our climate impacts while taking into account the diverse contexts in which we operate. We intend in particular to extend the Pro-climate approach, with the aim to systematically assess our clients' Paris Alignment for new operations with financial institutions (both earmarked and non-earmarked) by 2025. This will be done gradually, with a pilot phase in 2023 to test and refine the assessment methodology, the support modalities for both Transition Plan design and implementation, and the internal organization required to roll out the approach to all financial institution clients.

We will also seek to continuously improve our approach and methodologies based on experience and feedback from our clients, partners, and the DFI community. On this shared path of continuous improvement and raised ambition, we view it as a priority to develop a common understanding of Paris alignment and harmonized methodologies among peer DFIs and other interested public and private financial institutions, especially when working with common clients. In this regard, AFD is an active member of the *Financial Institutions Group on Aligning Financial Chains with the Paris Agreement*, an initiative supported by the Finance in Common Summit¹⁶ and coordinated by the Secretariat of the Mainstreaming Climate in Financial Institutions Initiative and UNEP-FI.

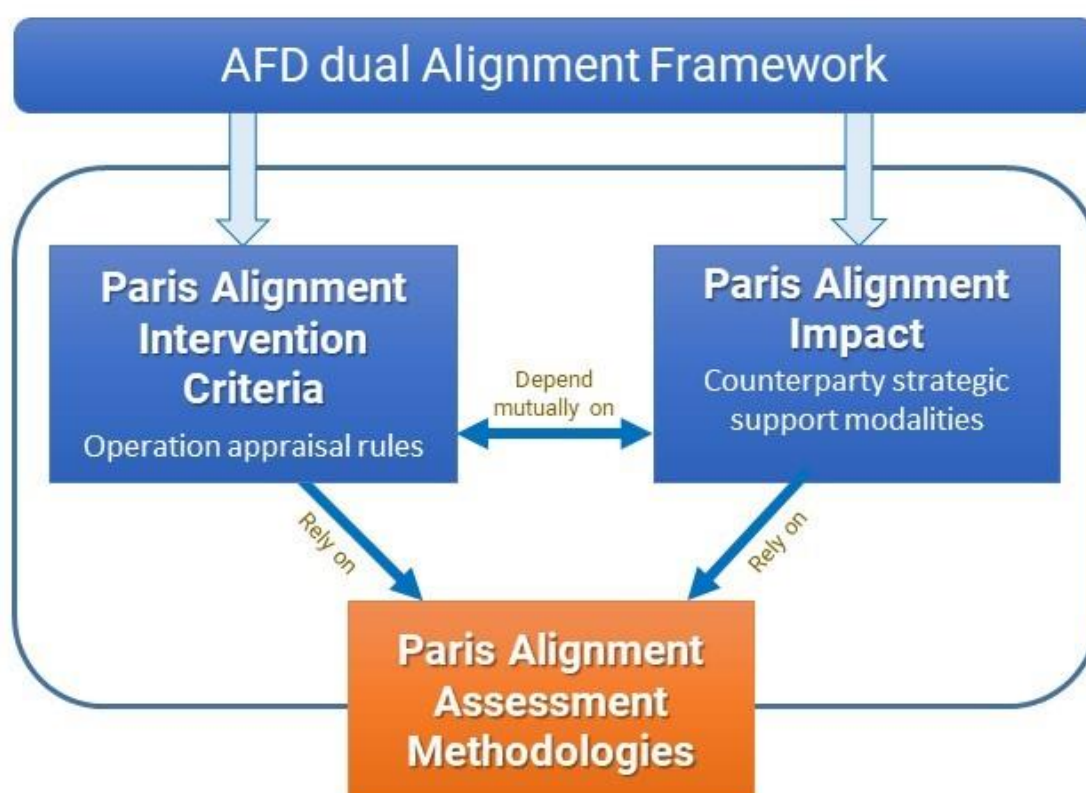
Moving forward we also intend to apply this general framework to other sectors and client types, prioritising those likely to have the highest systemic impacts, such as energy companies.

¹⁶ www.financeincommon.org

8. PARIS ALIGNMENT AT ALL LEVELS: OUR LONG-TERM VIEW

As outlined above, AFD considers Paris Alignment for DFIs to be an ever-evolving and improving dual set of (i) operation appraisal criteria (the Intervention Criteria component) and (ii) project/counterparty/system-based support for climate-related design, strategies and policies (the Impact component). Both of these components of Paris Alignment rely on the capacity to carry out Paris alignment assessments of underlying use of proceeds, counterparties, and systems/countries.

Figure 2. AFD Paris Alignment Framework



Source AFD

AFD believes that for DFIs, Paris Alignment involves the continuous raising of our collective ambition on each of these three interrelated components, and that this requires to move from a project-based focus to a counterparty and system-based focus, both for impact and accountability purposes.

Knowing when a given financing operation is Paris-aligned requires first to analyse the underlying use-of-proceeds, when applicable. But in time, and as expectations from third-party observers and stakeholders grow, DFIs are likely to include some proportion of context-specific and proportionate counterparty-level Paris alignment assessments and Transition Plan requirements in their intervention criteria. The same applies to the impact component, where DFIs are called to increasingly leverage their policy-based lending, technical assistance facilities and grant money access to support their

clients' and partners' climate strategies and policies. AFD recognises that, for DFIs, moving from project-based operations to counterparty- and country-based strategic support is key to making a significant contribution to the Paris Agreement goals.

9. A CALL TO INTENSIFY COLLABORATION BETWEEN DFIs

AFD has identified several challenges and questions that will be addressed in the coming months as the framework is further developed and refined, such as (among others):

- How best to combine qualitative and quantitative criteria when assessing Paris alignment of a financial institution?
- How to assess a FI's strategy, governance, policies, in a robust and coherent fashion?
- How to find the right balance between the intervention criteria and impact objectives and more specifically: what exclusion-policies make sense?
- How to further integrate adaptation considerations in counterparty alignment assessments and interventions?

Going forward, AFD will also investigate how to extend the above-described approach to other sectors and other SDGs.

AFD looks forward to exchanging views with our partners and peers on such matters and calls on DFIs and the broader Public Development Bank community, as well as private financial institutions and other relevant stakeholders to intensify discussions to elaborate coherent and compatible Paris-alignment frameworks that work across the diverse landscape of institutions and contexts. Such collaboration and cross-capitalisation should also make best use of inputs by think tank and research institutes, and of existing platforms such as, among others, the *Financial Institutions Group on Aligning Financial Chains with the Paris Agreement*.

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AFD Group implements France's policy in the areas of development and international solidarity. The Group includes Agence Française de Développement (AFD), which finances the public sector and NGOs, as well as research and education in sustainable development; its subsidiary Proparco, which is dedicated to private sector financing; and Expertise France, a technical cooperation agency. The Group finances, supports and accelerates transitions towards a fairer, more resilient world.

With our partners, we are building shared solutions with and for the people of the Global South. Our teams are at work on more than 4,000 projects in the field, in the French Overseas Departments and Territories, in 115 countries and in regions in crisis. We strive to protect global public goods – promoting a stable climate, biodiversity and peace, as well as gender equality, education and healthcare. In this way, we contribute to the commitment of France and the French people to achieve the Sustainable Development Goals (SDGs). Towards a world in common.