Legislative Overview

S-243, The Climate-Aligned Finance Act (CAFA)

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Contents

1.0 Introduction and Objectives of the Bill 1
1.1 Structure and Key Concepts 3
2.0 Key Features of the Bill 4
2.1 Superseding Public Interest Matter and Duty to Align with Climate Commitments 4
2.2 Target-Setting, Planning, and Reporting Requirements 5
2.3 Board Expertise and Absence of Conflict of Interest 6
2.4 Link Capital Reserve and Funding Requirements to Climate Risk Exposure 6
2.5 Financial Products Action Plan 7
2.6 Reporting on Implementation Progress and Reviews 8
2.7 Entry into Force 8

1.0 Introduction and Objectives of the Bill

A coherent legislative framework for the financial sector and federally-regulated businesses is needed to comprehensively achieve climate commitments in an orderly manner. Most financial reform proposals in recent years have centered on disclosure schemes that aim to identify and quantify the financial risks of climate change for businesses, in the hope that market participants and capital flows evolve accordingly. Unfortunately, this has not happened, squandering precious time the planet doesn't have if we aim to attain the goal of limiting global warming to 1.5˚C above pre-industrial levels, as my office's white paper, *Aligning Canadian Finance with Climate Commitments*, demonstrates.

Past experience, industrial accidents, environmental emergencies and financial crises have shown the limits of self-regulation by enterprises able to externalize societal costs while seeking the maximization of profits. Carbon pricing initiatives while useful to incent efficiency do not address the financing of fossil fuel production in excess of planetary boundaries. As financial institutions and high-emitting companies are not parties to the Paris Agreement, this significant gap in the governance of the financial system must be closed.

To do this Canada's financial regulations and commercial incentives must not only require climate risk disclosure but also alignment with Canada's climate commitments in the context of the ambition of the Paris Agreement and attaining net-zero emissions by 2050 at the latest.

This *Legislative Overview* describes a gold standard legislation titled the *Climate-Aligned Finance Act* (CAFA) developed with the assistance of dozens of international and national experts to ensure capital flows in Canada's financial system are fully aligned with international climate commitments now and in the future. This initiative is about changing the plumbing of the system that has failed to address the unprecedented climate crisis which has and will increasingly have dire economic and human consequences. The bill seeks to align the Canadian economy with the necessary goal of achieving Canada's national and international climate commitments by legislating the whole field of federal jurisdiction over financial and commercial regulation. Our approach is to do this in a way that respects Indigenous rights and ensures an equitable transition towards a net-zero emissions economy.

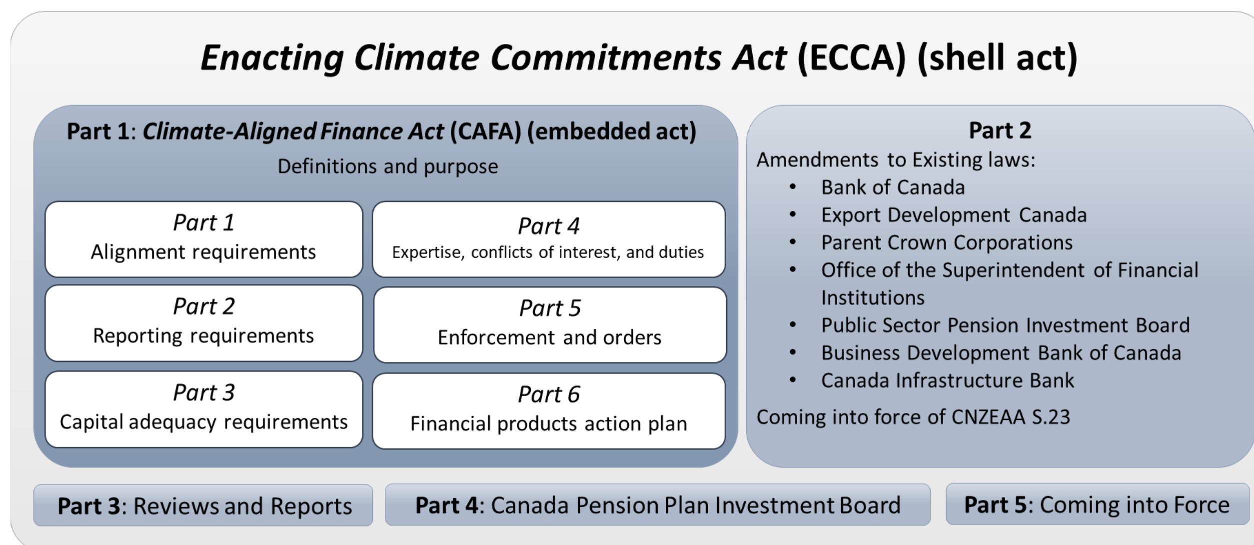
Purpose and Objectives

The purpose of the bill is to align the activities of federal financial institutions and other federally regulated entities with the superseding economic and public interest matter of achieving climate commitments. It aims to promote timely and meaningful progress with a view to safeguard the stability of both the financial and climate systems by recognizing the systemic risks posed by not aligning financial flows to all sectors of the economy with climate commitments. It will do so specifically by:

1) Establishing a duty for directors, officers and administrators to align entities with climate commitments;
2) Aligning mandates, including market oversight by OSFI with climate commitments;
3) Obligating the development of action plans, targets and progress reports on meeting climate commitments through annual reporting requirements;
4) Ensuring climate expertise on certain boards of directors and avoiding conflicts of interest;
5) Making capital adequacy requirements proportional to microprudential and macroprudential climate risks generated by financial institutions;
6) Requiring a government action plan to align financial products with climate commitments; and
7) Mandating timely public review processes on implementation progress to ensure iterative learning.

1.1 Structure and Key Concepts

The *Climate-Aligned Finance Act* (CAFA) has six parts and is embedded as Part 1 of the shell Act (the *Enacting Climate Commitments Act* [ECCA]) as illustrated below.



Key Concepts

CAFA defines a set of key terms which are referred to throughout the entire bill in the creation of new obligations and amendments to existing laws including in ECCA. The main definitions include:

Climate commitments means all of Canada's formal commitments under UNFCCC and COP decisions, national law and a specification of the national greenhouse gas emissions target of net-zero emissions by 2050 at the latest in the *Canadian Net-Zero Emissions Accountability Act*. Additionally, it includes four principles to address the main and gaps in the existing legislative landscape internationally and in the Canadian context:

i. Emissions[1] reduction on a pathway that respects a global carbon budget that ensures a high probability (66% or greater[2]) of limiting global temperature increase to 1.5˚C above pre-industrial levels with no or low overshoot based on the best available science and precaution.

ii. Elimination of dependence on, and lock-in of, emissions-intensive activities, including by avoiding new fossil fuel supply infrastructure and exploration for new fossil fuel reserves, and instead planning for a fossil fuel–free future;

iii. Preservation, enhancement and restoration of natural carbon sinks, including forests and peatland;

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[1] Emissions refer to all lifecycle emissions, including scopes 1 to 3, covering both upstream and downstream.

[2] The IPCC calculates global carbon budgets for 50% and 66% probabilities of limiting warming to 1.5 ˚C. The broader scientific community also models a global carbon budget at 83% probability of limiting warming to the same extent.

iv. Enhancement of the capacity to adapt and reduce vulnerability to actual and expected impacts of climate change, including by increasing the resilience of socio-economic, built and ecological systems.

Financial facilitation encompasses all possible types of financial assistance and services provided by financial institutions, on or off balance sheet.

Federal financial institution includes federally-regulated private entities such as banks, trust and loan companies, credit co-ops, insurance companies, pensions funds as well as the main Crown corporations involved in providing public funds.

Reporting entity means all federal financial institutions, as well as federally-incorporated corporations, and *federal works, undertakings or business* such as airlines, shipping, pipelines, and inter-provincial infrastructure.

Alignment with climate commitments means taking action that substantially contributes to achieving climate commitments and not facilitating another person or entity acting in a way inconsistent with climate commitments. It means refraining from exacerbating vulnerabilities to climate change like biodiversity loss or undermining remedies to redress climate harm. It also means having considerations that intersect with climate, such as respecting the rights of Indigenous Peoples as enshrined in UNDRIP, and – when undertaking climate related actions – refraining from fostering food insecurity, social inequalities or causing significant harm to social or environmental obligations recognized by Canada.

The bill attempts, except where unavoidable, to be sector and technology agnostic and to avoid referring to existing voluntary standards which could become obsolete and instead focuses on setting key parameters which are unlikely to evolve over the long lifespan of a law.

2.0 Key Features of the Bill

2.1 Superseding Public Interest Matter and Duty to Align with Climate Commitments

This bill exceeds the existing state of the law by establishing alignment with climate commitments as a superseding public interest matter affecting all entities covered by the Act.

All entities covered, including the Bank of Canada and the Office of the Superintendent of Financial Institutions (OSFI), will be required to carry out their objects and exercise their powers in a manner that is in alignment with climate commitments. The bill requires OSFI and the entities it regulates to be in alignment with climate commitments by adding a subsection to section 4 of the *Office of the Superintendent of Financial Institutions Act*. This amendment does not extend the powers and duties of the federal institution but only specifies that they must be deployed in a way that aligns with climate commitments.

Directors, officers and administrators of reporting entities will have a new duty to act in their official capacities to enable the entity to be aligned with climate commitments.

2.2 Target-Setting, Planning, and Reporting Requirements

The bill requires target-setting, planning, and reporting on climate commitment alignment for all reporting entities, unless they can demonstrate that they have no or negligible emissions.

Climate Commitments Alignment Report

The *climate commitments alignment report* demonstrates – with reference to the best available scientific evidence – how the reporting entity meets the description of alignment with climate commitments, provides details on the entity's emissions, targets, plans to reach the targets, progress on achieving the targets and implementing plans.

Specifically, reports must include:

1. A description of how the entity's targets and plans represent responsible stewardship of an equitable allocation of the global carbon budget based on the entity's historic emissions and the different development needs of regions and communities;
2. Methods, assumptions, and sources of information used to calculate emissions and verify the calculations; and
3. Information regarding any lobbying activity and positions put forward in partnerships, trade unions or associations on a matter related to the environment or climate.

Reports are annual and must be made public and freely accessible on the entity's website. For reporting entities who must provide financial statements or annual reports, these must include the climate commitments alignment report.

The government can assist in the development and preparation of these reports by providing tools, forms, or guidance to aid reporting entities in fulfilling their obligations. The government will also be expected to define *negligible emissions* for the purposes of exempting entities from the reporting requirements and may adapt any tools for small-scale entities.

Targets and Plans

Targets are set for five-year intervals starting in 2025 through to 2050.

Plans must include measures to prioritize and encourage immediate and ambitious action, emissions reductions within the value chain, and change and innovation to replace emissions-intensive activities. Plans must include operational and capital allocation and consider how executive compensation, governance, and strategy of the entity can ensure the achievement of targets.

Offsets may not be used as a substitute for reducing operating or financed emissions. However, offsets produced through permanent emissions removals may be used in cases where they are strictly necessary to neutralize minimal residual emissions that cannot be abated with existing technology. Plans and targets cannot rely on or presuppose the future invention, discovery or large-scale deployment beyond the remit of the entity's activities of any emissions removal, capture or storage technology to justify continued or increased fossil fuel activities. The use of either for limited purposes are subjected to additional detail and justification requirements such as third-

party assurance verification, direct contribution to making the future development or deployment possible and how it aligns with climate commitments.

Specific requirements will apply to federal financial institutions, which must have absolute emissions targets established at the sectoral and portfolio levels, and for individual investment holdings covering all their financially facilitated emissions. Further, federal financial institutions must engage proactively with the entities they financially facilitate. Their plans must include details on how the federal financial institutions incentivize decommissioning emissions-intensive activities, energy diversification and the development and adoption of change and innovation. Federal financial institutions must also escalate climate concerns and eventually exclude entities unable or unwilling to align with climate commitments from obtaining their financial services.

2.3 Board Expertise and Absence of Conflict of Interest

The bill requires that at least one member of the board of directors for Crown corporations involved in providing funding be a person with climate expertise as defined in the bill.

Further, a new conflict of interest requirement would apply to all reporting entities in two steps. For the first four years from entry into force, board members who work for, provide services for, lobbied for in the past five years, or who actively control stock in an organization that is not in alignment with climate commitments would have to declare it in the reporting entity's annual climate alignment report. From the fifth year onwards, such individuals would not be eligible for board appointments.

2.4 Link Capital Reserve and Funding Requirements to Climate Risk Exposure

The bill requires OSFI to develop new guidelines for capital adequacy in respect of climate commitments for financial institutions.

These OSFI guidelines will cover microprudential risks through increased capital risk weights for financial exposures that face acute transition risks, taking into account:

- The highest risk weight of 1,250% (1 for 1 rule) for any loan, bond or derivative exposure to new fossil fuel resources or infrastructure[3];
- Increasing risk weights to 150% or more for any loan, bond or derivative exposure to any fossil fuel activity[4];
- Differentiation in transition-risk intensity among oil, gas and coal exposures; and
- The existence of short-term climate action plans aligned with climate commitments.

The guidelines would also introduce a new systemic climate risk contribution capital surcharge that recognizes the extent to which financial institutions facilitate greenhouse gas emissions through all forms of financial facilitation. This surcharge will bolster resilience in the face of

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[3] Based on Lord Oates' proposed amendment to the UK *Financial Services Act 2021* which is also based on what Basel committee recommended for cryptocurrencies.

[4] Based on 2021 US *Climate Crisis Financial Stability Act* and work by the Centre for American Progress initiative *Addressing Climate-Related Financial Risk Through Bank Capital Requirements*.

systemic risks caused by financing emissions-intensive activities in excess of climate commitments. This new capital surcharge uses the institution's level of financially facilitated emissions as a proxy for the increased probability of default that financing emissions-intensive activities places on the financial system.

The guidelines described above would first apply to entities regulated by the *Bank Act* and be published within one year of the bill coming into force.

A second set of guidelines for funding requirements and investment policies in respect of climate commitments for pension plans, insurance companies and other entities that report to the Superintendent will be published within 6 months of the first set.

Six months after that, the President of the Treasury Board and the Minister of Finance would have to table in Parliament a report on guidelines for adequate capital, budgets, or funding in respect of climate commitments for Crown corporations and an action plan to make these guidelines binding through amendments to legislation.

2.5 Financial Products Action Plan

The bill requires the government to develop an action plan on necessary aspects of financial reform which cannot be legislated directly through the bill, namely:

- Collaborate with provinces regarding securities and aspects of bankruptcy laws in compliance with the constitutional division of powers.[5]
- Elaborate on fiscal/tax matters[6] or matters requiring a royal recommendation such as additional enforcement mechanisms[7]

The action plan will require consultation with various federal institutions and persons with climate expertise and must include:

- Criteria for identifying financial products whose purposes are aligned with climate commitments, taking into account CAFA and the best available international standards and science and justifying any departure from them;
- Mechanisms to prevent the proceeds of financial products whose purposes are aligned with climate commitments from being used for activities that are inconsistent with climate commitments;

[5] The federal government's jurisdiction does not reach some important aspects of financial regulation such as securities law which is provincial except when it comes to federally incorporated or regulated entities and federal Crown corporations.

[6] Under s.53 of the Canadian Constitution, bills that appropriate funds (i.e., involve the use of public funds) or that impose or increase taxes (i.e., money bills), must be introduced in the House of Commons and cannot be introduced in the Senate. Since this bill will be initiated in the Senate and we hope to avoid jurisdictional issues, we will not be proposing disincentives that may increase taxes or incentives that decrease them.

[7] Bills or amendments in both Chambers cannot infringe on the financial initiative of the Crown (i.e., executive branch), which has been interpreted as anything that imposes a charge on the public treasury, if it extends the objects or purposes or relaxes the conditions and qualifications specified in the royal recommendation that accompanies a bill or requiring one for non-government bills.

- A description of legislative amendments to the *Income Tax Act*, the *Income Tax Act Regulations*, the *Bankruptcy and Insolvency Act*, the *Companies' Creditors Arrangement Act* and other federal legislation needed to incentivize financial products that support climate commitments and to disincentivize the use of those that are inconsistent with climate commitments

A report containing the action plan must be completed no later than one year after the bill comes into force and the Minister must then, within 20 sitting days, table the report in both Houses of Parliament along with an analysis of the legislative amendments contained in the action plan and a proposal, including a proposed timetable, for making the legislative amendments recommended in the action plan.

2.6 Reporting on Implementation Progress and Reviews

Drawing inspiration from the *US Fossil Free Finance Act* s.4, the bill requires regular progress reporting on the alignment of Canada's financial system with climate commitments ensuring rapid iterative learning.

In a document tabled in Parliament every year, OSFI must report on the implementation progress with respect to regulated entities under its purview and the Minister of Finance will do so for Crown corporations.

Within a year of coming into force, the Bank of Canada, OSFI and representatives of Indigenous Peoples, will co-develop a report on consultations regarding Indigenous Peoples' perspectives on the activities of OSFI and the Bank, long-term investments, adaptation and resilience within the financial system and its stewardship for future generations. Another report will be prepared by the Bank of Canada on monetary policy as it relates to climate change, developed in consultation with persons with climate expertise. The reports must be tabled in Parliament.

Every three years after entry into force, an independent review of the provisions and their administration must be conducted in consultation with persons with climate expertise and result in a report within nine months of initiation, to be tabled in Parliament.

Every three years, a comprehensive review of the provisions and their operation is to be undertaken and completed by a committee of the Senate, of the House of Commons or of both Houses of Parliament that is designated or established for that purpose.

2.7 Entry into Force

The proposed legislation comes into force one year after royal assent to give industry time to adjust; this is standard in the EU.

However, amendments to the *Canada Pension Plan* and the *Canada Pension Plan Investment Board Act* (Part 4 of ECCA) only come into force if the Lieutenant Governor in council of each of at least two thirds of the included provinces – within the meaning of subsection 114(1) of the *Canada Pension Plan Act* – having in the aggregate not less than two thirds of the population of all of the included provinces, has signified the consent of that province to the enactment.