Global Counsel

Pricing sustainability: the financial sector's role in green finance

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Summary

Sustainable finance refers to a financial service that incorporates environmental, social and governance (ESG) factors into business and investment decision-making.While market-driven initiatives currently set the metrics for this area, its uptake by financial regulators has been slow. In the year following the 2008 financial crisis, sustainability rested on the periphery of long regulatory debates around the vulnerabilities of a globally systemic financial system through the filter of prudential, accounting and supervisory reforms. But investors and regulators alike are beginning to view "climate-proofing" the financial sector as a means to an end, to help mitigate both the physical and investment risks arising from a non-financial factor – climate change. With $1tr in annual investments required over the next 36 years to keep global warming below 2 degrees, policymakers are contemplating whether a top-down approach would better ensure that the private finance community delivers. Should this regulatory "push" be flexible or narrow, incentivising or penalising? And how successful can regulators be in transforming a historically short-term investment environment to one that values the long-term potential of sustainability?

In the last two years, we have seen a growing link between finance and climate change policies. Regulators, such as Financial Stability Board Chair Mark Carney, see this link as crucial towards tackling the "tragedy of the horizon" – a scenario where the costs of climate change burdens future generations so long as there is no direct incentive for the current generation to mitigate them. The desire to accelerate the global low-carbon transition has thus triggered further interest of how the financial sector operates in this largely unregulated space. The 2015 Paris Agreement suggested $93tr would be needed to reach global carbon-reduction targets by 2030. That same year, the FSB found a small measure of renewed multilateral purpose in identifying climate-related threats to financial stability and assessing potential reforms to prepare the financial sector for adjusting to a "green" future.

A number of trends are merging here. One is the obvious interest in mobilising private capital in meeting the Paris Agreement targets and UN Sustainable Development Goals. Another is the growing acceptance of ESG factors as being material in themselves to the valuation of assets and their performance over time. This might be a question of an insurer's exposure to flood risk, or a creditor's exposure to trapped carbon assets. It might be a more general view that investors are choosing to factor this criteria into investment decisions. What unites these positions is a general view on the desirability of moving capital out of 'brown' carbon-intensive assets and into 'green' ones. What both raise is the question of how the market prices both green and brown – and how robust that pricing is.

Pricing green

The more policymakers and investment managers have looked for ways to incentivize investment in the low-carbon transition and market climate-friendly investment as an asset class, the more the question of definition has become central. The uncertainty around what constitutes a "green" investment is central to both marketing such assets and any attempt to risk-score them in a differential way.

Green bonds illustrate the challenge. First pioneered by development banks back in 2007 to raise money for climate-friendly projects, they have become a niche but highly-fashionable investor choice. There was a global record of $155.5bn in green bonds issued in 2017 – including 12 new issuers - and an estimated $250bn to $300bn expected in 2018. Institutional investor demand is high;

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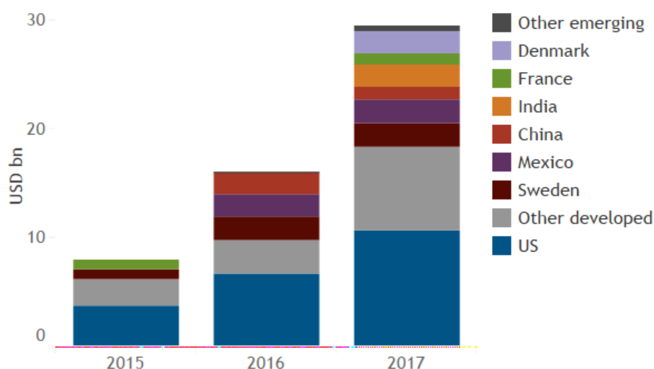
arguably higher than for which the store of credible investment opportunities can currently provide. Moreover, the expansion of the asset class raises inevitable questions about standardised sector definitions of what makes a bond green.



Source: Climate bonds

Regulators are seizing upon the growing demand and supply of green bonds to justify closer scrutiny and intervention, partly reacting to the loose approach emerging in China, a booming green bond market where even "clean coal" projects have qualified as being green. To improve transparency and traceability of green funds, some are considering prohibiting green bond issuances in the absence of certain prerequisites or moving towards a mandatory disclosure scheme on green bond use. The EU High-Level Expert Group on Sustainable Finance, for example, seeks to improve disclosure rules under the EU Shareholder Rights Directive and align the EU Non-Financial Reporting Directive with the FSB guidelines, as well as clarify the mandate of its European Supervisory Authorities when it comes to ESG criteria.

This quantification of ESG factors in lending could go one of two ways – it could end up narrowing the definitions of green lending materially, or it could take a lowest common denominator approach. One sets a high bar for companies not yet on the road to transition, the other has potential to make regulation less effective than desired, at least for investors who really value clear kitemarking. This does not even begin to address the dilemma of active versus passive investing. Investment firms with a majority of their portfolios in indexed strategies have little discretion over how their capital can be deployed – will the climate-related risks to their portfolios be interpreted along the same ESG benchmarks set for the rest of the financial sector?

Some of these definitional questions become acute when the question of capital relief is linked to such lending. Proposals to minimise the amount of loss-absorbing equity required under prudential rules for such assets are live in the EU. While critics argue that reducing capital requirements in an innovative, highly speculative area contradicts the risk-averse approach more appropriate for the asset class, the European Commission seems partially convinced. However, the European Banking Authority's research on the similar SME supporting factor in post-crisis banking legislation suggested that a 25% risk-weighted adjustment tends to have little effect on lending: a 50-150% change would be more effective. With ratings agencies already suggesting that such distortions could have a negative impact on lenders' credit ratings, it is not clear how much mileage the idea ultimately has. Nevertheless, if the EU does take this path, others can be expected to follow.

Pricing brown

Getting money out of 'brown' carbon-intensive investment is no less of an issue for policymakers. Here, the tool of disclosure is clearly the instrument of choice. Policymakers are drawn to the idea that markets might use disclosure to start pricing carbon-intensive assets more robustly. This approach was notably at the heart of the FSB's 2017 guidelines on climate-related financial disclosures. But since 2016, there have been 86 ESG disclosure mechanisms in a wide range of OECD and non-OECD markets. As regulators begin thinking about making these mechanisms mandatory– see France's Article 173 energy transition law – the divergence in approaches between them becomes a material issue.

In the mirror image of the debate on a "green supporting factor" on capital, the question of a "brown penalising factor" – or "brown add-on" as policymakers are now opting to call it - has been raised, above and beyond the uncertainty or stigma that some policymakers would like to see attached to carbon-intensive assets. No less than its green variant, this would raise important questions of definition.

Aside from these issues of definition, one possible flaw here is the presumption that all markets are in an equal position when it comes to fossil fuel alternatives. Higher charges for fossil fuel activities can increase economic inequality as the concentration of lending shifts from carbon-based areas to environmental-friendly markets. This would hurt smaller economies highly dependent on fossil fuels, or which lack the infrastructure or expertise to transition as quickly as other markets – including some emerging African countries. Even in Europe, the discussion of the idea has added to the tension in an already fragile relationship carbon-reliant Poland has with the EU.

A brown penalty would also expose the practices of central banks, putting institutions like the European Central Bank in an uncomfortable position, given its own quantitative easing programme has largely benefited the high-carbon sector. According to

the Grantham Research Institute, 62.1% of ECB corporate bond purchases come from manufacturing, electricity and gas productions that are responsible for 58.5% of eurozone greenhouse gas emissions. Many policymakers would like to see public investors like central banks serving as a role model, even though green incentives and brown disincentives are both difficult ground for central banks to be taking the lead on.

Where do we go from here?

While there are some precedents for dealing with these kinds of challenges in asset pricing, there is arguably nothing on the scale and ambition of the low-carbon transition and the desire to use financial incentives to give it momentum. But trying to combine the ambition of the Paris Agreement and the desire to see the low carbon transition funded can be an uneasy fit with financial disciplines, objective and consistent standards of disclosure and the effective pricing of risk.

Despite these challenges, we can be sure that policymaker attention will remain. Expectations on company managers and Boards are rising. If France and the rest of the EU are any indication, a trend towards legally redefining the fiduciary duty to investors is already underway. As of last December, 237 companies from 29 countries pledged to implement the FSB guidelines within 3 years. The FSB has already committed to reporting on the progress at this year's G20 summit in Argentina.

The years ahead seem sure to define 'sustainable' in new, important and material ways. The more these approaches are codified and standardised the more companies will find themselves being benchmarked against peers by external rather than internal standards. For both companies and investors, the challenges ahead seem likely to focus on making sure that the data and concepts that underpin these initiatives is robust and that diverging approaches do not confuse or weaken them.

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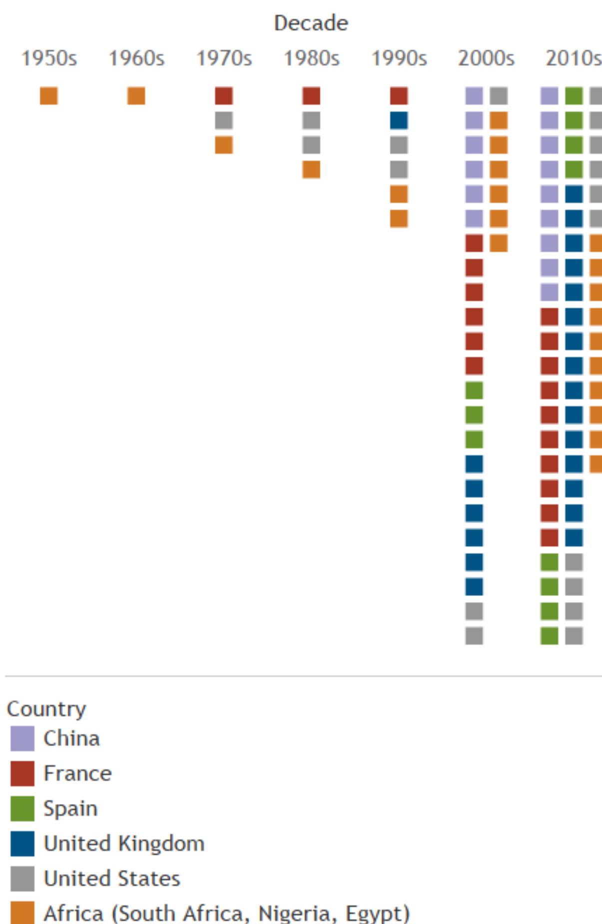

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