Green finance: investors need transparency

The effects of climate change have become increasingly palpable for the general public in recent years, with wildfires having destroyed large parts of the Amazon rainforest and the Australian bush, killing more than a billion animals. The attention on the topic, including the need to reverse the inexorable decline in biodiversity and promote sustainable livestock production, has been heightened even further due to the coronavirus outbreak.

Stopping the disruptive effects of climate change requires prompt and effective responses at all institutional levels – supranational, national and local – as well as by all individuals. The financial industry can play a crucial role in ensuring an efficient transition to a low-carbon world that is guided by market signals rather than diktat, but only if certain conditions are fulfilled.

It is obvious that climate and environmental risks should be carefully factored into investment and lending decisions, but unfortunately such risks are still just an afterthought for most. Although in surveys three quarters of investors say they would like to take into account sustainability criteria in their choices of asset manager, it is striking that in companies' investor day meetings only 2% of slides are typically dedicated to climate risks. There is clearly a mismatch. Accurate and consistent disclosure in corporate financial statements would help investors decide which firms are making progress, and which companies are the laggards to be avoided. Governments need to enforce rules that enhance the transparency of private companies' actions. Only then can investors and financial intermediaries make objective decisions on which 'green' projects and companies they wish to finance.

Voluntary disclosure and subjective methodologies lead to unreliability

To detect companies' engagement in green projects, one indicator that could be used is their adherence to the Environmental, Social and Governance (ESG) principles, which could be assessed through the assignment of an ESG score. However, under the current framework, there are no clear rules for disclosure practices by individual firms, nor any reporting auditing standards to verify the data. Consequently, ESG-score providers rely upon data that are voluntarily disclosed by firms and base their assessment on subjective methodologies that select, assess and weigh individual ESG indicators.

This process can lead to potential arbitrary scores, which cannot be relied upon by financial markets and investors. The academic literature has observed that the ESG scores assigned to the major listed companies in the euro area by three of the main providers vary significantly for the same firm, while the correlation between the more traditional credit ratings is over 90 per cent.

Greenwashing left unchecked and loss of trust

The current opaque situation is clearly open to abuse by unscrupulous firms. It should come as no surprise that many companies seek a mere marketing return out of their "green" initiatives, instead of a full commitment to the cause. By enhancing transparency, it would be possible to single out those company engaging in so-called "greenwashing", in which the label "green" is used for all the production activities and financial investments and intended to mislead potential customers. In the past, some of the most successful green-washing campaigns have ironically been implemented by some of those firms most culpable for the current climate crisis, such as multinational oil companies. If greenwashing is left unchecked, there is a risk that the public will lose trust entirely.

The first step to improve the situation is creating a harmonised taxonomy, definitions and standards for green finance. Supranational bodies can play a crucial role in defining high-level standards that should align the actions undertaken by the countries around the world. For instance, the Task Force on Climate Related Issues (TCFD), a body created by the Financial Stability Board (FSB) in 2015, made up of 32 financial experts from around the world and chaired by Michael Bloomberg, has implemented an important initiative in this direction. The TCDF came up with 11 recommendations touching upon different areas, from corporate governance to risk management and strategy, aimed at producing voluntary, consistent climate-related financial risk disclosures for use by companies.

In September 2019, the United Nations launched its admittedly somewhat generic Principles for Responsible Banking, which have been signed by 150 global banks, including virtually all European ones. Thirty-one banks even took it a step further and signed the Collective Commitment to Climate Action, in which they pledged to align their portfolios to reflect and finance the low-carbon, climate-resilient economy required to limit global warming to well-below 2 degrees Celsius. Another valuable step forward was achieved on 9 March 2020 when the European Commission published the "Sustainable Finance: Technical Expert Group (TEG) final report on the EU taxonomy". National governments should now contribute more proactively through the promotion and endorsement of these initiatives, as they create multiple beneficial effects.

Investors as enforcers

If these consistent standards are implemented and monitored independently, investors can then play the role of enforcers of market discipline, with the ultimate result of rewarding those companies behaving genuinely "green" with the provision of funds at cheaper rates. More reliable information might also help financial markets assess more accurately the exposure of companies to climate change.

According to the Network for Greening the Financial System (NGFS), there are two main climate change risks. First, "physical risk", which includes the economic costs and financial losses resulting from the increasingly severe and frequent extreme climate change-related weather events, such as heat waves, landslides, floods, wildfires and storms. Second, "transition risk", which is related to the process of adjustment towards a low-carbon economy — in particular, the process of reducing emissions is likely to have significant impact on all sectors of the economy, affecting financial asset values.

With enhanced transparency, banks and external investors will be able to better appreciate the efforts of companies to change their business models, making it more sustainable and green-friendly, thus producing a fairer economic valuation. In June 2019, recognising the importance of climate risks, the European Banking Authority published a consultation paper on loan-underwriting standards, proposing that financial firms should take into account environmental factors, i.e. physical and transition risk, in their credit policies and risk assessment process. And in May 2020, the European Central Bank also issued a consultation on its guide on climate change, which inter alia highlighted the importance of high quality disclosures.

Divesting from fossil fuels

Some financial actors have already taken definitive action. The European Investment Bank, for instance, has banned the financing of all fossil fuel energy projects by the end of 2021, and aims to align all of its financing activities with the goals of the Paris Agreement by the end of 2020. Other European and global banks have also pledged to stop lending to thermal coal, or the oil and gas industry, in particular projects drilling for oil in the Artic; or they have introduced targets for financing renewable energy projects. Norges Bank Investment Management, one the world's largest investors, with on average 1.5% of the shares of every company in the world, recently announced that it had sold of some of the biggest names in commodities and utilities, including Glencore, Anglo American and RWE, after concluding that they breached its guidelines on the use of coal. At the same time, there is a huge amount of work to be done. Few banks currently disclose their exposures to high carbon industries. According to the European Commission's Action Plan published in March 2018, close to 50% of the exposure of euro area institutions to risk is directly or indirectly linked to climate change.

Credit vs climate risk

In order to speed up progress on sustainable finance and encourage the banking industry to take climate risks into account, some proposals ask regulators to assign lower risk weights to green projects and higher risk weights to so-called "brown" lending. This would raise the return on capital of green versus brown projects, thus incentivising the former. This is a seemingly attractive way to promote sustainable finance. But unless the risk weights accurately reflect the differential climate-related credit risks faced by a company, which will be very difficult to do in a risk-sensitive manner, they will be potentially distortionary, resulting in wrong credit risk decisions and, in the worst case scenario, systemic problems, such as overlending to particular segments. It is better for risk weights to reflect purely credit risk.

On the other hand, if financial intermediaries have clear and comparable data, they will be able to better appreciate the risks and potential of the green projects themselves. The evaluation of these projects is currently extremely difficult as it requires financial intermediaries to assess the return generated on the assets over a very extended period of time. The selection of the best projects could help allocate capital efficiently, taking also into account that most of the latest public initiatives are meant to boost investments in this sector, such as the European Green New Deal.

Enhanced transparency, by providing more clarity on the issue, could therefore contribute to improving the risk management practices that financial intermediaries will put in place to counter the climate change effects on their activity. Ultimately, more clarity on the topic could also benefit financial regulators and supervisors in deciding on actions to mitigate the risks of climate change to financial stability.

Clear and auditable transparency

We believe that by defining clear and auditable transparency obligations for companies in matters related to climate change could be the most market-efficient way to serve the future of green finance investment. Reliable information will benefit both the companies themselves, which will be able to borrow at cheaper rates and achieve an improved reputation, and investors, who will have a more reliable assessment of the projects. It is in the financial industry's and companies' own interest to take initiative sooner rather than later, in particular as the new generations of investors – i.e. millennials and generation Z – are much more sustainability-driven than their parents.

Disclaimer: The views expressed in this article are those of the authors and do not necessarily reflect the view of their employers.

Notes:

- *This blog post expresses the views of its author(s), not the position of the ECB, Banca d'Italia, LSE Business Review or the London School of Economics.*
- *Featured image by naturfreund_pics, under a Pixabay licence*
- *When you leave a comment, you're agreeing to our Comment Policy*

Date originally posted: 2020-05-28

Permalink: https://blogs.lse.ac.uk/businessreview/2020/05/28/green-finance-investors-need-transparency/

Blog homepage: https://blogs.lse.ac.uk/businessreview/

Benedict Weller is a principal supervisor in the Single Supervisory Mechanism at the European Central Bank. He was previously principal economist in risk management at the ECB between 2012 – 2016, senior expert in TARGET2 securities between 2009-2011, and prior to that economist in the ECB's monetary policy operations from 2001-2008, focusing on liquidity and collateral management. Between 1998-2000, he was editor of the Central Banking Journal in London. He has a BA and a master's degree in economics from Jesus College, Cambridge University.

Michelangelo Bruno is an on-site inspector in the financial supervision department at Banca d'Italia. Previously, he was supervision analyst in the ECB's Single Supervisory Mechanism between 2015 – 2017 and research and teaching assistant at Bocconi University's finance department between 2013 – 2014. He holds a MSc in accounting, financial management and control from Bocconi University and a Master's in political economy from LSE.

Date originally posted: 2020-05-28

Permalink: https://blogs.lse.ac.uk/businessreview/2020/05/28/green-finance-investors-need-transparency/

Blog homepage: https://blogs.lse.ac.uk/businessreview/