



## **Climate Change and Finance**

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Ladies and Gentlemen,

In a remarkably short time, financial markets have been transformed from a threat to sustainable development to the best hope for a gradual transformation towards more sustainable production and consumption patterns. Erstwhile critics can be forgiven: short-termist, unsentimental and by definition concerned with private rather than social benefit, financial markets, their actors and institutions have little to endear themselves to the environmental or social activist. And yet, there is mounting evidence that financial markets currently play a key role, maybe the key role in promoting and ensuring sustainable development. In the following I would like to provide you with a brief overview of the most important initiatives before presenting a concrete proposal how we can scale promising beginnings into an even more serious mutually beneficial relationship.

- (1) The most visible role of the financial sector in promoting sustainable development is in the organisation of environmental markets such as the emissions markets for sulphur dioxide in the United States or carbon dioxide in Europe. The European Emission Trading System constitutes now a market with underlying assets of 50 billion Euros. That number is to set to increase substantially once the global market for CO<sub>2</sub> emission allowances through the Clean Development Mechanism will come into full swing. Other markets of this sort – say for fertilisers or pesticide, renewable energy certificates or energy efficiency obligations – may follow. Clearly, the financial sector has an interest in the establishment of such markets as do environmentalists and governments.
- (2) A growing number of share indices now concentrate on companies satisfying certain criteria in terms of social and environmental performance. The most widely known are the FTSE4Good, the NASDAQ Clean Edge or the Dow Jones Sustainability Index. While these efforts occupy currently respectable niches, there is hope that this will change soon with a series of dedicated carbon indices profiting from the rapid professionalisation of carbon markets. Two of such indices by UBS and Merrill Lynch have been launched in the past few weeks, a third is in preparation. By concentrating on the intuitively simple and reliably measurable criterion of carbon emissions per value added or turnover, these indices have the potential to appeal both to institutional investors – some of whom are under pressure by their trustees to commit a certain amount of their funds to ethical investments – and retail investors.

- (3) The management and trading of ethical and carbon funds: this is one segment of the market that has not yet fully delivered on its transformational potential, mainly due to the fact that the measurement and verification of “ethical” criteria beyond carbon emissions is fraught with methodological differences and social acceptance issues. Despite the best efforts of organisations such as EIRIS in the United Kingdom for environmental issues or Vigeo in France for social governance issues neither the information issue nor the acceptance issue has made much progress. Socially responsible investment or SRI is an issue where the potential is immense but the appropriate foundations have not yet been laid. I will come back to the issue at the end of my presentation.
- (4) Conditionality for project financing: the “Equator Principles” coordinated by the International Finance Cooperation has been a huge success. They oblige project financiers to assess and manage social and environmental of the projects they finance and to resort to regular reporting about the project’s impacts. The list of institutions having signed up to the Equator Principles is a who’s who of international banking and is growing steadily. As you know, the Equator Principles were also recently included in the OECD Recommendations on Environment and Export Credits.
- (5) More prosaically, the financial sector actively contributes to sustainable development through the securitisation and financing of long-term liabilities, may they concern toxic waste clean-up, nuclear power plant dismantling or pension obligations. The latter is a social sustainability issue, if there ever was one.
- (6) Accident and disaster insurance and “adaptation”; the absence of sustainable development manifests itself not only in terms of ephemeral environmental use values. From the dramatic to the banal: increased storm activity, rising flood levels and decreasing snow cover in ski resorts destroy real assets and impact economic activity. The consequence of rising insurance premia is forcing slow changes in behaviour. People are moving – at sometimes substantial monetary cost -- further away from the shoreline and further up the mountains. While imperfect, one should not underestimate the importance of such subterranean movements to raise awareness and ultimately policy changes on a more systemic level.
- (7) Resource scarcity: it may not seem this way. But what is currently happening in commodities’ markets the world over goes beyond the dream of the most committed Malthusian environmentalist concerned about natural resources. For the first time, financial markets are not only reflecting but anticipating at an unprecedented scale the progressive exhaustion of finite global resources in the face of ever-growing demand. We may still see a reversal of the trend. But if current price levels, notably in the energy sector, last the impacts on everything from the efficiency of cars and appliances, production and consumption patterns, emission intensity will be enormous.
- (8) Last but not least, let us not forget that the financial industry is by far the sector with the lowest ecological and carbon footprint per unit of value added. Buying and selling things creates a lot less emissions than actually making them.

This is an important list. There exists indeed a lot of creativity and substantial demand for “ethical” investments. We need, however, to underline two points. First, while carbon trading, project finance and long-term liability funding are large markets, the market for true ethical investments is still small, measured in the tens and hundreds of millions rather than billions. Second, all of these important, welcome and frequently exciting opportunities depend crucially on the preparatory work of the public sector, governments and civil society.

Financial markets and sustainable development have not meshed earlier because the decentralised decision-making taking place in private markets relies on prior established “common knowledge”, shared perceptions, norms and values. In order to buy or sell a tonne of carbon, traders need to be assured that they are dealing with a socially and privately valuable commodity rather than with the haphazard and passing notion of a fringe group. Establishing “common knowledge”, defining, measuring and legitimising the goods, services and processes that have an impact on sustainable development is a social, collective, political in short, process. This process is all the more difficult as many sustainability challenges are characterised by complexity, uncertainty and long-term dynamics. This is why they were off the radar screen of traditional markets. However progress in societal preference formation and technology allows today progress on fronts, where in the past transaction costs would have put limits on the codification of relevant issues.

Carbon markets, the brightest spot in sustainability finance, could only take off once the world’s governments had agreed on the Kyoto Protocol, a process involving thousands of bureaucrats and experts and spanning more than ten years from 1992 to 2003. Europe’s EU ETS depends on painstaking negotiations about National CO2 Allocation Plans. These efforts come on top of the diligent work over two decades of establishing protocols, negotiating conversion factors and delineating perimeters for the measurement of carbon emission. Both the OECD and the IEA have made considerable contributions to this process.

All this to say: the financial sector needs the public sector and governments to create the rules, conventions and products to establish markets for sustainable development. Only then, they can employ the dynamism and imagination to integrate those considerations into the wider economy for its own benefit as well as for ours.

Let me conclude with a concrete proposal: the OECD is ideally placed to organise a process involving governments, industry representatives and independent experts to develop a set of OECD Guidelines for Ethical Investment Funds. The timing is propitious. Much – albeit very dispersed – research has already been generated. Currently are lacking (1) a concerted effort to integrate the existing mass of different criteria into generally acceptable guidelines and (2) the legitimacy for any set of guidelines that only an intergovernmental organisation like the OECD can bring. I truly hope that the OECD Secretary General will seize the opportunity to create an initiative for OECD Guidelines on socially responsible investment in the coming months.

Thank you for your attention.