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A Future to Invest In: Why Green Finance is Gaining Ground

Article by Aaron Sterniczky
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Read the business press and you will see more discussion of climate change and green finance than ever. How should we understand this apparent turn from an industry not known for sustainability or long-term thinking? The rise of green finance is not down to a change of heart. Rather, as Aaron Sterniczky explains, a look at the fundamental principles of the market reveals why it needs to adapt fast, for its own sake.

When Larry Fink, CEO of BlackRock, the largest global investment management corporation, addressed the audience during the Venice International Conference on Climate this summer, he set out to convey a clear message. The gathering, held in July 2021, marked the closing of an official meeting of the G20 finance ministers and central bank governors in the lagoon city. Larry Fink urged the official representatives of the international monetary community to do nothing less than put the core principles of climate action at the centre of an overhauled financial system. Some commentators compared the spirit of the discussions ahead of the summit to the ambition shown at the Bretton Woods conference which, in 1944, designed a sound financial structure for the West's post-World War II economy.

The rising importance of ESG

Superficially, Fink's lecture can be regarded as a condensed set of ideas that outline a tendency that has been evolving for years: the growing importance of ESG investments in the asset portfolios of big and small financial players. ESG stands for "Environment, Social, Governance". These three letters capture a rising awareness that financial investments carry responsibility for a wide range of stakeholders and that markets need to respect ethical standards when deciding about the flow of investments.

While research into the question of whether strict compliance with ESG standards also leads to higher returns remains inconclusive, the rising significance of ESG considerations are already visible from investment patterns. Bloomberg Intelligence estimates that by 2025, the sheer volume of ESG assets will have grown to at least 50 trillion US dollars, compared to 22.8 trillion dollars a decade earlier. While ESG currently shows an annual growth rate of 15 per cent, the expectation goes that by the mid-2020s ESG-labelled assets will represent a third of all global assets under management.

Faced with the climate crisis, this shift towards ESG needs to accelerate. In 2020, global investments into the renewable energy transition amounted to 303 billion dollars according to estimates by Bloomberg New Energy Finance. However, as reported by a joint publication of NGOs, the 60 largest global banks financed activities of the fossil fuel

industry worth 750 billion dollars over the same year. The notion that investment into the fossil fuel industry declined compared to year before, whereas investment into renewables rose, appears as little comfort given the overall situation.

To push this development further, regulators should clarify what can be legally regard as ESG-compatible, ideally through international frameworks to unambiguously define the meaning. The EU sustainable finance taxonomy is a step in that direction.

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Risk and reward

The question remains as to why financial actors are so eager to promote the transition towards climate action. Why is ESG sensitivity is growing? Given that the exuberance, excess, miscalculations, and astonishing lack of risk awareness in the financial sector led the world economy to the brink of collapse in 2008, its claim to wish to avert environmental breakdown seems suspicious at first glance.

Rather than attributing this change to a presumed deliberation about the institutional responsibility of banks or catharsis in the financial sector, it should instead be understood within the systematic considerations embedded in the operating logic of financial markets. All too often the behaviour and daily business of financial markets appear opaque. Colourful charts on desktops depict ominous performances, murky terms, and complex formulae. For outsiders and insiders alike, it can be difficult to understand what this is all about. Clarifying the core purpose of financial markets might help to overcome intimidation or confusion.

Five principles need to be taken into consideration to understand how modern finance works. First, financial markets assess the price one must pay to borrow money, the cost of capital. Second, the costs of money are basically defined by the risk involved and attached. Third, the riskier an investment, the higher the costs. Money is priced according to the riskiness of the investment. Fourth, financial markets are the dedicated structures that modern societies have created to exchange risk against money. Fifth, the common perception of risk recognises that even the ordinary course of things might be interrupted by unexpected changes of circumstances. Normality must be able to deal with possible interferences, but diversified portfolios manage to rebalance this insecurity and allow risks to be softened.

Financial markets pair certain attitudes to risk with corresponding rewards. The higher the risk one is willing to take, the higher the potential gains must be (since the potential losses are more severe as well). Practical theories such as the “capital asset pricing model”, probably the most important framework in equity markets nowadays, directly correlate the riskiness of an asset to the costs of capital.

Assessing the riskiness of an investment depends on two reference values: risk-free assets and the returns achieved by the entire market. Risk-free assets would be US treasury bills or bonds issued by the European Central Bank because they do not carry any specific risk. Even investing in risk-free assets rewards lenders with interests on the investment. Assuming for the sake of argument that the interest rate on a national bond is 2 per cent, this means that avoiding any risk would be rewarded with an interest rate of 2 per cent. An investor could also decide to hold a portfolio that resembles the market as a whole. This means taking on the risk inherently present in the market, and is referred to as the systematic risk. Assuming again for the sake of argument that the value of a fully diversified market portfolio grows by 8 per cent annually, then in this case, taking on the systematic risk results in a return of 8 per cent. The difference between the risk-free asset – interest rate of 2 per cent – and the market yield – interest rate of 8 per cent – would amount to 6 per cent, the so-called market risk premium. To sum up, accepting no risk at all guarantees a reward of 2 per cent, taking on the systematic risk in the market is compensated by 8 per cent, and so the premium equals 6 per cent.

To take Germany as a real-world example, the actual risk-free rate would be close to 0 per cent for German government bonds and, according to current publications by the Institute of German Auditors, the market risk premium lies between 6 per cent and 8 per cent.

To get deeper into the matter, investment in any company can be evaluated according to the risk involved. Some projects might carry lower risk than the market itself while others may involve higher risk. A water utility is usually less exposed to the volatility of market developments, while launching a new collection in fashion retail would be comparatively more risky. The interest rates expected as remuneration for lending money to a water utility are therefore lower than those sought for investments into the fashion industry. They are lower because they are less risky, but both are calculated based on the principle of a risk-return relationship investors expect. The common conviction that drives this approach is the assumption that market agents behave in a rational manner and no single player can beat the market in the long run. So, no one is willing to invest money in a fashion retailer on the same terms they would invest in a water utility.

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Investment into the unknown

This reasoning is the prism through which to understand the meaning of climate action for financial markets. Any investment requires a dedicated risk assessment as a precondition, because risk assessments determine borrowing costs. Risk assessments deal with the likelihood of unforeseen events, but they do so based on a fundamental assumption of overall predictability and the certainty that modern market structures will prevail. Otherwise, the whole concept would be unsound. The entire approach of contemporary risk management is based on the idea that disturbances are likely, within a world of continuity.

Climate change alters that radically. An unconstrained climate crisis would lead into a world permanently confronted with discontinuity to a degree and on so many levels that any risk assessment would appear futile and almost nostalgic.

If, therefore, the climate crisis is not merely regarded as a meteorological phenomenon but as an age we are entering, a period shaped by the alteration of the earth's system, then many historical achievements will lose the foundation on which they are built. What is obvious for infrastructure, farming, energy systems, production, urban planning, and politics is also relevant for finance.

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As unmitigated climate crisis would mean a world forced to cope with an unpredictable future, green finance appears as the only viable option for financial markets that wish to continue to be able think ahead. To frame it differently: you can only invest in the future if a predictable one exists. A world beyond 1.5 degrees of warming means conditions unknown to our species, entailing upheavals that cannot be priced into reasonable risk scenarios.

A climate system in the Anthropocene and the severe changes it would bring would lead to risk scenarios impeding future investments. Since ecological meltdown causes disruption on all levels, there looms the danger that making any investment will cease to make sense. The risk premium that must be integrated into the cost structure of financial assets would simply be too high and would representing a major obstacle to investment strategies and financial markets as we know them. Green finance is the reaction to that prospect. The concept must today be understood as an expression of the growing awareness that only a profound economic transition towards sustainability will allow for a future to that can be invested in; this is the essential reasoning behind the development known as green finance.

Given the future that lies ahead, it will not only be the understanding and application of sensible concepts that helps to make the ecological transformation a reality. As COP26 in

Glasgow showed, key players in central banks and investment companies seem, at least intellectually, ready to achieve net zero by rearranging the institutional and theoretical framework finance is operating within. Sound finance and monetary policy will dedicate itself to this task in the upcoming decade: showing intellectual courage, promoting institutional and legal innovation, redefining outdated modes of macroeconomic thinking, and shaping once unthinkable alliances between different parties, including between central bankers and ecologists. The world needs to move ahead.

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