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Opinion piece from Ministry of Finance

The sustainability revolution in finance

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Opinion piece by Minister for Financial Markets and Consumer Affairs, Deputy Minister for Finance, Per Bolund on December 26, 2015.

A quiet revolution is taking place in the financial industry. According to the United Nations Environment Programme, sustainable development is increasingly being integrated into financial decision-making.

The European Union has been rather passive so far in this transformation, but financial regulators in a number of countries are leading the charge. France recently introduced the world's first mandatory climate disclosure requirements for institutional investors. Norway is divesting its sovereign wealth fund from coal. South Africa has embedded sustainable development into listing requirements on its stock exchange.

Likewise, Brazil's banking regulations now require accounting for environmental risk. And the Swedish government is pushing an ambitious sustainability agenda featuring a series of proposals aimed at improving information for investors and determining which climate-related risks regulators and financial firms must address.

Private industry is also moving rapidly. The world's largest asset manager, Blackrock, is launching a fossil-fuel-free index, and Axa, one of the world's largest insurance companies, has pledged to divest from coal.

Meanwhile, the divestment movement is snowballing, with faith-based communities, municipalities, celebrities, trade unions, universities and institutional investors all pledging to unload their fossil-fuel assets. Altogether, institutions worth more than $2.6 trillion have committed to divest from fossil fuels.

The revolution may be quiet, but it is getting louder. Fossil-fuel companies are increasingly being delegitimized; their current business model is irreconcilable with a climate-conscious investment portfolio.

At the same time, investors are starting to understand that paying attention to climate risk is an integral part of a sound investment strategy that seeks to minimize risk and help to promote financial stability. Axa's CEO Henri de Castries has endorsed such motives, stating that divesting from coal helps remove risk from investment portfolios and contributes to building a more sustainable society.

Bank of England Gov. Mark Carney has been particularly frank in highlighting the dangers that climate change poses to financial markets. In a speech at Lloyd's of London in September, he cautioned that a delayed transition to limit global warming to 2 degrees Celsius would increase risks to financial stability. A range of institutions has echoed his warning.

Meanwhile, McKinsey and the Carbon Trust have estimated that 30 to 40 percent of the value of fossil-fuel companies could be endangered because of a "carbon bubble," an overvaluation of fossil-fuel reserves.

According to the International Energy Agency, two-thirds of these reserves must be kept in the ground if the world is to avoid runaway climate change, which implies that companies may not be able to exploit their full economic potential. Given that the European financial sector has invested more than €1 trillion ($1.1 trillion) in fossil-fuel assets, the EU is particularly at risk of a carbon bubble.

The issue has become serious enough that European Central Bank President Mario Draghi has asked the European Systemic Risk Board to investigate it. Financial regulators in Sweden, Germany, the Netherlands and the United Kingdom are all studying the impact of climate change on financial markets. The Group of 20 has also asked the Basel-based Financial Stability Board to convene a public-private inquiry into the carbon bubble.

Last September, European Commissioner Jonathan Hill published his long-awaited Capital Markets Union proposal. But while his call for more integrated and diversified capital markets in the EU is admirable, his proposal lacks both a road map for the integration of sustainable development into the financial system and a strategy for addressing the carbon bubble.

The European Parliament and the European Council have the opportunity to improve Hill's proposal. The parliament has already established an informal cross-party grouping, called the Carbon Group, which aims to tackle the carbon bubble and advance sustainable finance. And within the council, a range of countries, most notably Sweden and France, are working for greater integration of sustainability metrics into financial markets.

A range of institutions are starting to embrace sustainable development considerations in their financial decision-making. Policymakers — especially in the EU — have a responsibility to advance such forward-looking thinking and to protect the global economy from climate-induced financial distress.