IIF Green Finance Workshop

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– Check against delivery –

Timothy, thank you.
Ladies and Gentlemen,

Introduction:

- I am delighted the IIF is hosting this Green Finance Workshop. This is an invaluable and a timely effort. Green finance and carbon risk – two sides of the same coin – have lately attracted significant attention.
- This certainly is not before time. For too long we have been flying blind into the world of climate risk. But the low-carbon transition is on its way to lift the world onto a new, sustainable level of development; and it is high time to adjust and take advantage of the opportunities the transition provides.
- The historic accord agreed at COP21 in Paris last December has changed the political context by ensuring a credible approach to stabilising global temperatures well below 2°C (above pre-industrial levels). And staying within 2°C of warming is not a goal or a target, it is an obligation. 2°C is the threshold beyond which the risks become unmanageable.
- It is in line with this UN process that alongside ratification of the Paris Agreement, for example by the US and China, governments in Brazil, China, France, Indonesia and elsewhere have launched first steps to specifically deal with the issue of carbon risk and green finance. Equally, the G20 have initiated the development of a modern low-carbon finance agenda, which I believe provides impetus for an efficient, stable and sustainable financial system. Indeed, China has shown invaluable leadership in this regard. Germany, taking over the G20 presidency from China, will have to further elevate the issue.
- In my remarks, first, I would like to briefly highlight the opportunities, which are huge but challenged. Second, I will focus on the issue of risk and the complexity of exposure since I am convinced tackling risk comprehensively is the precondition for steering successfully through the transition, and building a sustainable economy and equitable society. Finally, I will suggest four actions to move forward.

Challenged opportunities:

- BlackRock, the world's largest asset manager with US$4.89 trillion under management, recently concluded that "all asset owners can – and should – take advantage … of climate related investment tools and strategies … [to]

seek excess returns or improve their market exposure."

- Pension funds and insurance companies – the asset owners at the top of the financial chain – are the institutions in society with amongst the longest time frames. They are increasingly recognising the risk and opportunities of climate change and wider Environmental, Social and Governance issues.
- New financial instruments, such as green loans, green bonds, green investment trusts and funds, green indices and ETFs, constitute potential business opportunities for many financial firms. For example, the green bond market has taken off in recent years, with $42 billion issued in 2015; approximately four times the issuance in 2013. This growth is set to continue, with issuance topping $50 billion by September 2016. (Climate Bonds Initiative)
- However, success has not been comprehensive, as the example of ETFs shows. While the number of "green" ETFs has increased 50% in the past two years due to optimism about future demand, the category's assets have averaged only about $1 billion since the products were first launched a decade ago. In aggregate, the funds have underperformed the S&P 500 this year, with higher volatility. (Bloomberg Brief)
- Also, further action is required to shift the financial system to support investment in sustainable infrastructure. Establishing some forms of infrastructure as a distinct asset class could help make it a standard part of investment portfolios and unlock access to large pools of capital, such as from institutional investors.
- This is pointing to a number of challenges to be tackled sooner rather than later, including
    1. The absence of clear definitions of green finance activities and products;
    2. The use of unreliable data concerning the exposure to carbon emissions;
    3. The mismatch between the risk/return profile of divesting from publicly-traded fossil fuel company shares and re-investing in green infrastructure.
- For finance to play its proper role, investors large and small need to gain experience. They may even have to learn new ways of thinking in order to grapple with both the risks and challenges of being stuck in the old, high-carbon economy as well as with the opportunities in low-carbon investment. Governments will have to establish and flesh out appropriate frameworks and guidelines to mitigate carbon risks and foster green investment opportunities.

<u>Three types of risks:</u>

- Some of you will have heard in recent debates that we should be very careful that the "sub-prime" crisis that triggered the Great Recession is not repeated as a "sub-clime" crisis through mismanagement of climate change. Behind that inspired bit of shorthand is a growing body of research and policy analysis.
- Mark Carney, the Governor of the Bank of England, outlined in his path-breaking speech in September last year the "tragedy of the horizon", and

elaborated it recently in a thoughtful speech to the Atlantik-Brücke in Berlin, both of which I strongly recommend to this audience.

- In a nutshell, his concern is that possible climate effects on asset values may still be beyond the planning horizons of businesses and policymakers. And by the time they manifest themselves, the cumulative nature of climate impacts means the opportunity for action has passed.
- There are three types of risk we think about here: Physical risks, liability risks and transition risks. Mark Carney himself says, and I agree, that the most immediate financial stability risks are probably in the last of these categories. Policy and technology in particular can move very quickly, and destroy asset values as fast as they boost others.
- Anyone who does not believe that only needs to look at the impact of the German energy transition – the Energiewende – on the values of formerly blue-chip utilities such as RWE and E.ON. The energy giant E.ON's non-renewables spinoff Uniper made its debut on the Frankfurt stock exchange a couple of weeks ago. In August, E.ON put the book value of Uniper at approximately EUR 12bn. Current expectations are though that the market valuation will be less than half of that.
- In a similar vein, the announcement that Peabody, the world's largest private sector coal miner, filed for bankruptcy sent shockwaves through the fossil fuel industry. These cases should act as a warning about how fast things can change.

Complex exposure:

- There are no guarantees that economic transitions happen smoothly. Usually in fact they do not. But my plea today is that the climate transition need not be like that. It is eminently possible for businesses to analyse their asset portfolios according to any number of useful yardsticks.
- The think tank Carbon Tracker shows that on average 60 - 80% of coal, oil and gas reserves of listed firms are unburnable in a 2 degree world. As an investor, I would want to know which reserves are unburnable and which are not. I would want to know plausible views of when those assets might need to be written off, and I am more worried if this happens in a disorderly fashion, and more relaxed if it happens in an orderly way over an extended time horizon.
- We learnt to our cost during the global financial crisis that it is not enough to understand the static exposures of individual financial institutions to potentially impaired assets. It is critical to understand how these exposures change in different risk scenarios, and look at them not only in terms of the <u>equities</u> financial actors hold but crucially also the much larger exposures banks hold in <u>loans</u> to non-financial corporations. We must then understand in a networked way how they interact through cross-holdings, and what the implications are for system stability as a whole.
- Using empirical data of the Euro Area, Battiston et al show that while direct exposures to the fossil fuel sector are small (3-12%), the combined exposures to climate-policy relevant sectors are large (40-54%), heterogeneous, and possibly amplified by indirect exposures via financial counterparties (30-40%). So the numbers are not trivial. Far from it.

- Let me rewind to the global financial crisis then. Wouldn't we have liked to know – say back in 2001 – exactly what assets were sitting in exotic structures like collateralised debt obligations, and how these might behave under various house price scenarios? Well, this is what we need now in the world of climate risk.

4 Recommendations:

- As the broader financial system adjusts to reflect the realities of building a sustainable, low-carbon future, it needs to count on the support of credible, transparent and lasting frameworks. Let me therefore conclude by putting forward four specific actions which I am convinced are necessary to ensure a smooth transition:
    1. **Strong, effective and rising carbon prices:** A price on carbon is a necessary condition for inclusive and low-carbon growth. Around 40 countries have implemented or scheduled carbon pricing. China, for example, will establish a national emissions trading system in 2017, expected to be the largest in the world. France adopted a carbon tax on transport, heating and other fossil fuels in 2014. Other governments should follow suit.
    2. **Appropriate disclosure:** Enhancing climate-risk disclosure, whether related to physical impacts or risks associated with stranded assets, is fundamental in the transition to a low-carbon economy. The Task Force on Climate-related Financial Disclosures, which was established under the Financial Stability Board at the request of G20 Finance Ministers and is chaired by Michael Bloomberg, will soon come up with a number of recommendations. The G20 should make sure they act upon those recommendations and take them further.
    3. **Comprehensive learning:** Beyond disclosure there must be analysis and learning. Since all actors, private and public sector, investors and policymakers alike are trying to estimate and understand this new risk typology at the same time, there appears to be a case for the learning to happen simultaneously, perhaps via a private/public sector knowledge-sharing platform. Assessing the importance of mandatory disclosure at least as an eventual goal should certainly be part of the agenda. Following the strong Chinese leadership as far as carbon risk and green finance is concerned, this could be a major contribution from the G20, with an important role for Germany as the 2017 host.
    4. **Green financial sector:** A systematic approach to "greening" the financial sector – including private banks, MDBs, institutional investors etc. – and their investment decisions to reduce their exposure to high-carbon assets will be vital. This includes reaching agreements around definitions and certification, and ensuring implementation. We need suggestions and action from the finance sector.
- Green finance and carbon risk – two sides of the same coin – have lately attracted attention. Action must follow urgently. We live under a misapprehension if we think this is of no concern to us personally and professionally. If we embrace the low-carbon transition though in line with

the “better growth, better climate” agenda put forward by the Global Commission on the Economy and Climate on which I gladly serve as a member, we will contribute to building equitable societies and sustainably growing economies, which can stand the test of time.