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Action on climate change – The Finance perspective

Dr Anne-Marie Coles,of the Institute for Political Economy, Governance, Finance and Accountability (PEGFA), University of Greenwich, says the link between finance and climate change needs to be understood.

by Dr Anne-Marie Coles | University of Greenwich - July 5, 2019

CLIMATE CHANGE

There is growing recognition that the role of finance is crucial in the planning and execution of solutions to the climate crisis. New approaches to financial management are already emerging but potential problems need to be more widely understood for new financial products to be developed.

Commons. However, this does not compel the government to change its current target, reduction of carbon emissions by 80% (compared to 1990 levels) by 2050.

Compare this to the action taken by some local authorities which have already gone further, aiming to be carbon-neutral by 2030, and planning to introduce electric car hubs or build sustainable homes in pursuit of that goal. There is certainly a developing sense of crisis across many social and business groups, with an acceptance that it will be necessary to make substantial changes, in order to find positive solutions to the need for sustainable transition.

As Lord Deben, chairman of the UK's Independent Committee on Climate Change has said, recognition of climate urgency 'is *only credible if policies are introduced to match'. The need for novel solutions poses a challenge for financial investment where embedded processes tend to follow a routine structure for lending decisions. As Dr Jin Chan, an expert in green energy comments, for a large company in the fossil fuel sector, 'one renewable energy project is too small, the expected return too low to be considered a good R&D investment'.*

One of the main issues for finance lies in the area of risk assessment for insurance premiums. This is an area that will face challenges as climate change impacts start to become more frequent and pronounced. There is an emerging scientific consensus behind the suggestion that we can expect such disruptive climate related events to take place.

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Rapid changes to the climate have been documented over the past 40 years. These range from warming of the oceans, rising sea levels and increased levels of carbon dioxide in the atmosphere. Changes have happened more rapidly than can be attributed to natural sources. The US National Academy of Sciences has predicted extreme climate impacts to take place this century if carbon emissions continue unchecked and believes 'there could be broad-based disruption of the global economy unparalleled by any event other than World War II'.

These would include heat waves and droughts as well a flooding, hurricanes and storms, impacting on agriculture and habitat destruction possibly resulting in a 'mass extinction event'. But this catastrophic scenario can still be averted by action taken now. On the international stage, targets to control emissions were set and agreed on in 2016 by 197 signatories to the Paris Agreement.

This agreement set nationally determined contributions to reduce greenhouse gas emissions designed to achieve net zero emissions by 2050. Countries are expected to take decisive and far reaching actions such as **e**nding subsidies for fossil fuels and agriculture while encouraging use of renewable energy and electric powered mobility.

Role of finance

Where does finance fit into the picture? It is difficult amid the complexity of the problem, to identify exactly how individuals or single organizations can adopt new practices that can contribute to the need for change. The European Union has identified both infrastructure maintenance and carbon emissions reduction from energy use as two of the most important challenges for the region.

This clearly implies that both private and public financial decisions will be involved, due to the cross cutting issues for businesses in all sectors of the economy. The impacts of climate change are thought to pose most risk to infrastructure and buildings particularly where there is poor design or a vulnerable location.

This is particularly relevant given their long life span and their high initial cost of construction. For energy there is a pressing need for transition to low carbon generation, also the unpredictable effects of climate change could impact both patterns of supply and demand. Other sectors that will experience significant impacts include agriculture and forestry and tourism.

Changes in these areas will particularly affect the insurance sector, where premiums would be affected in response to extreme weather events. This industry will have to increasingly take climate disruption into account in planning and risk analysis. The United Nations has highlighted the role of finance as one of six sectors with potential to impact greenhouse gas emissions.

This would require a cross sector mobilizing of both public and private sources of finance to encourage adoption of cleaner, more resilient practices. However, the financial implications for business also include the cost of damage and disruption resulting from climate impacts and the potential for firms to show explicit understanding and strategies for climate risk planning.

For the financial sector there are certainly both potential contributions to be made as well as the changing nature of financial risk to be managed. In terms of insurance for the UK, damage can be expected to property from more frequent fire, floods and droughts, leading to higher and more frequent claims translating into increased premiums.

Also developments could result in insurance becoming unavailable in some areas, leading to losses for uninsured investments and assets. In addition there are financial issues involved in a widespread shift from fossil fuel based industries towards a low carbon economy. Companies which are now linked to the exploitation of fossil fuels can expect a reassessment of their operations potentially driven by increasingly stringent regulation and widespread adoption of carbon neutral technologies.

However, we can expect new sectors and opportunities to emerge based on sounder ecological principles. One factor to consider, however, is that older companies with interests, assets and supply networks are more likely to be larger, and more established but financially less flexible or unwilling to invest in alternative opportunities.

The new ‘greener’ economy may be initially dominated by small firms which are financially insecure, although undoubtedly, one of the new growth sectors will be based on existing ethical finance as this already includes investments for example in renewable energy technologies.

As Dr Chan comments, ‘the green bank and new financial instruments are very important requirements for moving forward in the financial sector’. The high uncertainties which exist around both potential for increasingly stringent regulation and for novel disruptive technologies to rapidly emerge highlights the necessity for sound financial management to be informed of potential change and to ensure their planning and portfolio strategies are resilient enough to withstand rapid adjustments.

In the UK the need for the financial services industry to build knowledge and capacity regarding assessment of risks posed by climate change has been recognized. The Financial Conduct Authority(FCA) and Bank of England’s Prudential Risk Authority (PRA) have jointly been involved in establishment of the Climate Financial Risk Forum (CFRF). This body includes members from financial institutions including banks, insurers and asset managers with the intention of sharing information on managing financial risks associated with climate change.

Large companies have responsibility not only to protect shareholder investments but also to a wider group of stakeholders. This latter category will include many who actively exert pressure for a more rapid change to greener, less polluting practices by business.

As climate change issues continue to gain visibility and urgency, firms can expect to face increasing levels of scrutiny for their choices and action in support of a smooth transition to more sustainable practices. As such, actions will have financial implications, whether from decisions to invest in more energy efficient technologies and waste reducing processes.

Here the implications are that an increased capital investment could also result in savings made over the longer term in terms of energy operational and material bills. The aim must be to invest wisely to future-proof the business against unwanted devaluations, exposure to risk or expensive investment mistakes. Dr Athena Piterou, a researcher into sustainable business development notes, 'the governor of the Bank of England has recently identified the importance of the financial sector in addressing the climate crisis'.

Investor power

There is no doubt that firms currently involved in the fossil fuel and extractive sectors face the greatest threat from increasing social and political concern over the environmental impact of their activities. This raises concerns for continuation of insurance and underwriting activities.

The sectors themselves are already under criticism, allegedly for attempting to suppress and obfuscating knowledge on climate change. The apparent reluctance of companies in this sector to take decisive action in redirecting their operations or in mitigation of their activities has led to what some term 'financial activism'.

The power of shareholders, which are also large institutional investors, to threaten divestment is beginning to engender palpable change in firms' strategies. A good example of this trend is the role played by large investors such as the Church of England Pension Board voting in favour of Royal Dutch Shell to set clear targets for carbon emissions.

As Dr Piterou notes, 'divestment has already affected companies in the fossil fuel sector, but financial fund managers can be very successful in changing the activities of companies from within'. This trend to hold companies to account can be understood as the convergence both of the growing public concern over the need for responsible action by fossil fuel companies and realization of increasing financial risk for investors if companies refuse to take responsibility or resist change.

The need for governments who are signatories to the Paris Agreement to meet their emission targets has implications for making the transition from fossil fuel to cleaner and renewable generation technologies. These trends indicate a shift in focus by the financial sector, where short term gains are beginning to seem unsustainable in the longer term unless action is taken on climate change.

It is clear that, when large institutions take the threats seriously, positive change can result. This sentiment was echoed in a speech by Sir James Bevan in June when he said we 'have the capacity to get ourselves out of this mess. The right policies, the right innovation, the right attitude, the right lifestyle – all of these are in our gift.'

It certainly now seems the right time for the financial sector to step up and consider making plans for a cost effective transition to a sustainable future.

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