Sustainable finance – redirecting global financial flows

Our present social and economic system is not sustainable. The Earth's critical limits are already exceeded – be it as a result of climate change, biodiversity loss, land-use change or human interventions in biogeochemical cycles. Humanity is consuming its environmental capital.

A key lever influencing the shift towards better climate protection and sustainable management of global resources is transformation of the financial system. For on the one hand, massive investment is necessary worldwide in order to achieve the United Nations' Sustainable Development Goals. According to information from the OECD, the World Bank and the International Energy Agency, several billion US dollars a year need to be directed into health, education, renewable energies, food security and environmental protection.

On the other hand, vast sums are incessantly being poured into investment funds, stocks, bonds and other financial products which meet few environmental and ethical criteria, if any. Many investors still consider these as lucrative as ever and speculate on high returns.

A redirection of global financial flows thus represents a powerful lever if the aim is to release money for sustainable investments and at the same time withdraw the resources that underpin environmentally or socially harmful undertakings.

Sustainable investment reduces risks

Furthermore, the warming of the global climate poses considerable risks to the stability of the financial market. Events caused or intensified by climate change, such as storms, droughts or floods, can have direct or indirect impacts on the financial system – for example, if uninsured damages result in losses of corporate value and hence a higher risk of credit default. These are known as physical risks.

The global transformation towards climate neutrality is also affected by transaction risks. If the CO_2 price suddenly rises, for example, and if this has not been accounted for in investment activity, many stocks can drop massively in value. If they become altogether worthless, they are known as "stranded assets".

Hence, a reorientation of the financial sector is also relevant with a view to preserving the efficiency and stability of global financial markets.

Stricter criteria for financial products

The new way of thinking that is taking hold in and on behalf of the financial sector can be felt on various levels. More and more financial market players are considering sustainability criteria in their capital market and investment decisions. In the financial sector these are commonly known as ESG (environmental, social and governance) criteria.

These range in spectrum from minimal exclusion criteria, such as nuclear power, weapons or tobacco products, to stringent positive criteria favouring explicitly "green" or "sustainable" investment products. For example, such positive criteria may include environmental and climate protection standards, respect for human rights, fair working conditions or corruption prevention. "Impact investing" goes a step further and aims to achieve measurable positive impacts on the environment or society at the same time as generating a positive financial return.

So far such ambitious investments are still niche products but sustainable financial products are attracting growing interest from private and institutional investors.

Diverse actors striving for change

Since about 2012 the "divestment movement" has called upon institutional investors and private individuals alike to take their money out of fossil energy companies and move it into sustainable investments. In the meantime, more and more universities, cities, insurance companies, pension funds and foundations around the world are withdrawing financial resources from carbon-intensive fossil industries.

A shift is also happening on the policy level: for example, the European Commission drew up an action plan for the reform of financial markets in early 2018 and, among other proposals, aims to develop a classification system for sustainable finances. In Germany, the Council for Sustainable Development (RNE) and the stock exchange Deutsche Börse AG have founded the Hub for Sustainable Finance (H4SF), while the German Government has also taken up the theme and established a Sustainable Finance Advisory Council.

How does a sustainable financial system need to be configured?

In a project self-funded by the institute, researchers at the Oeko-Institut are pursuing the question of how the financial system needs to be configured in order to promote sustainable global development.

Given that sustainable financial flows are known to have a structural lever effect and that the financial sector consequently influences many fields of environmental policy, the project is exploring questions such as which methods are currently in use for the integration of ESG risks and which barriers are faced by financial sector actors who wish to act more sustainably.

While on the one hand a large amount of research remains to be done in relation to the thematic complex of sustainable finance, on the other hand the processes and discourses currently under way are in many cases dominated by financial sector actors. The Oeko-Institut considers independent research to be especially important and is therefore supporting this project from its own funds.

Frameworks for climate investment

Commissioned by the German Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (BMU) and in cooperation with Business Communications Consulting GmbH and the Ecologic Institute, researchers from the Oeko-Institut have investigated how the legal and regulatory frameworks in Germany influence investment in climate action.

The German Commercial and Social Codes and legislation on capital markets and investment, accounting and taxation can contain legal barriers to climate protection investment whilst also neglecting to set the necessary incentives for financiers and capital seekers.

The fields of investment studied include “Energy efficiency in companies”, “Infrastructure measures in the construction and transport sectors”, “Generation, transportation and storage of renewable energies” and “Conservation of forests as carbon sinks”. For five especially significant barriers to investment, the project participants worked up proposed solutions and reflected on these in workshops with stakeholders.

Among these proposals were approaches to streamline the inordinate amount of regulation in the German Investment Code (Kapitalanlagegesetzbuch, KAGB) concerning citizen energy projects, in particular, and to create more legal certainty in this area. The team of experts also made recommendations about tax incentives for investments in climate protection.

Oeko-Institut project: “Rahmen für Klimaschutzinvestitionen” [Frameworks for climate investment] commissioned by the BMU (information in German)

Further information

Study (in German): *“Umweltschutzorientierte Fortentwicklung des Kapitalanlage- und Investmentrechts”* [Environmental protection oriented development of investment law] by the Oeko-Institut and BCC Sustain Growth GmbH under commission from the German Federal Environment Agency (Umweltbundesamt, UBA)

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Oeko-Institut is a leading independent European research and consultancy institute working for a sustainable future. Founded in 1977, the institute develops principles and strategies for realising the vision of sustainable development globally, nationally and locally. The institute is represented at three locations in Germany – Freiburg, Darmstadt and Berlin.