Leibniz Institute for Financial Research SAFE

SAFE Finance Blog

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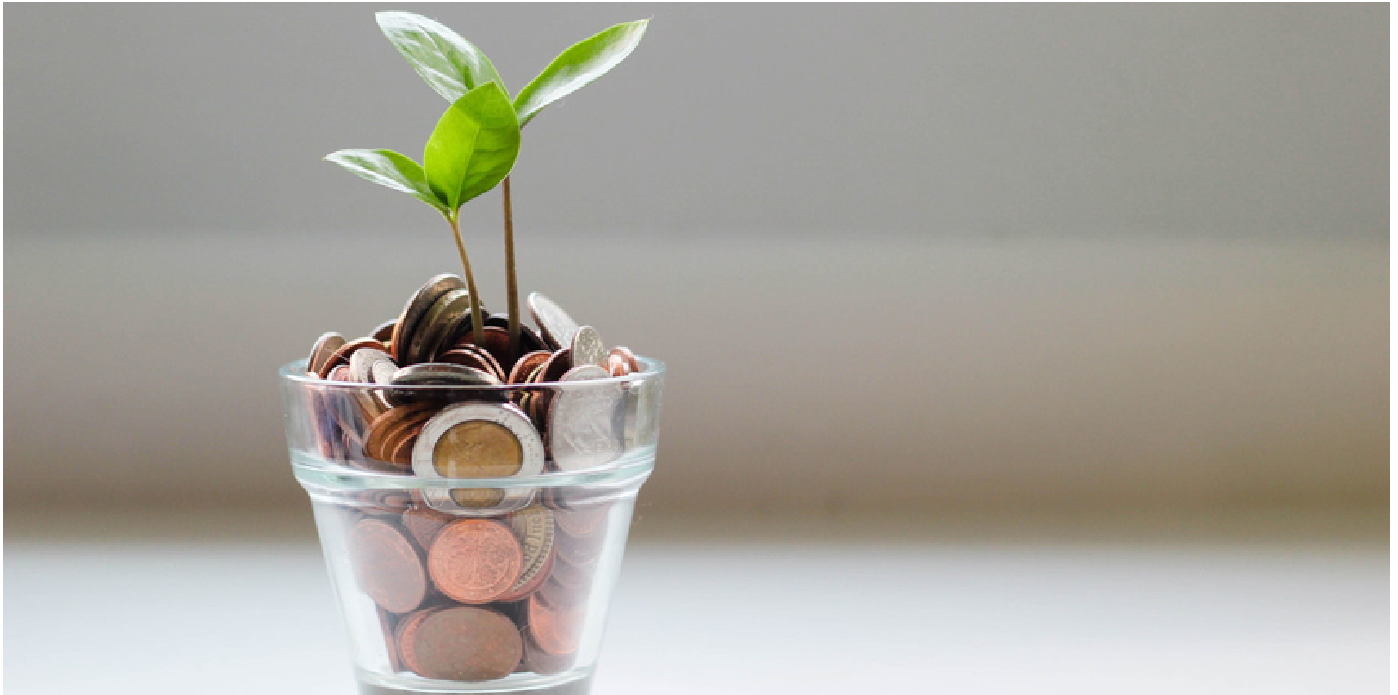
The role of disclosure in green finance

Mandatory disclosure obligations can improve the availability and quality of the information which investors need to allocate capital in line with "green" investment strategies



Anthropogenic climate change is a reality that will impact incrementally on all areas of human life, including economic activity and the social welfare it creates. Policy makers around the globe have attempted to tackle the threat climate change poses to social welfare and ultimately human existence, including through regulatory interventions that seek to align the allocative function of financial markets with sustainability objectives. The primary tool in these green finance initiatives is an abundance of disclosure obligations. These obligations pursue the overarching objective of providing deeper and more comparable information on the climate impact of investments, broadly understood. Rational investors receive a superior knowledge base upon which to make informed decisions, which would channel more capital into "green" activities and de-fund "dirty" ones, ultimately leading to a transformation of the economy induced by market discipline. The regulatory intervention is aimed at unhinging the steady state and ushering in a new, "greener" equilibrium by inducing a shift in capital supply.

In our recent SAFE Working Paper No. 320, we study the design features of disclosure regulations that seek to trigger the green transition of the global economy and ask whether such regulatory interventions are likely to bring about sufficient market discipline to achieve socially optimal climate targets.

Categorizing transparency obligations

In the first part of our paper, we illustrate the regulatory model by surveying the regulatory initiatives currently pursued in jurisdictions around the world. We categorize the transparency obligations stipulated in green finance regulation as either compelling the standardized disclosure of raw data or providing quality labels that signal desirable green characteristics of investment products based on a uniform methodology. Both categories of transparency requirements can be imposed at activity, issuer, and portfolio level. Our two-dimensional distinction of categories and levels provides a useful framework for characterizing individual legislative interventions and for analyzing the functional rationale of green finance disclosures in general.

In the second part of our paper, we examine the theoretical consistency of the prevailing approach towards green finance which puts increased transparency in center-stage. We do so by looking at what drives investors' decisions to acquire or shed "green" or "dirty" assets and the equilibrium effect the respective investor preferences may exert on asset prices. Finance theory and empirical evidence suggest that investors may prefer "green" over "dirty" assets for both financial and non-financial reasons and may thus demand higher returns from environmentally harmful investment opportunities. A carbon premium which could lead to more favorable financing conditions for "green" firms compared to "dirty" ones is not only theoretically plausible but also empirically observable. However, the market discipline that this negative cost of capital effect exerts on "dirty" issuers is potentially attenuated by countervailing investor interests in broad diversification and does not automatically lead to socially optimal outcomes, not least because macro-modelling of climate impact is fraught with tremendous uncertainty.

Transparency-based green finance regulation comes with private and social costs

In the third part of our paper, we ask why and to what extent there is a role to play for government intervention in fostering the production of information which investors may need to make investment decisions that will result in the desired re-routing of capital. We draw on the large body of literature that analyses the pros and cons of mandatory disclosure obligations in financial regulation in general. We find that mandatory disclosure obligations and their (public) enforcement can indeed play an important role in green

finance strategies. They prevent an underproduction of the standardized high-quality information that investors need to allocate capital according to their preferences. Private sector solutions do not represent an equivalent because of the public good characteristics of standardization. However, the rationale behind regulatory intervention is not equally strong for all categories and all levels of "green" disclosure obligations.

We briefly comment on corporate governance problems and other agency conflicts in intermediated investment chains and conclude that they do not represent a categorical impediment for green finance strategies. However, the many forces that may prevent markets from achieving socially optimal equilibria render disclosure-centered green finance legislation a second best to more direct forms of regulatory intervention like global carbon taxation and emissions trading schemes. Yet, inherently transnational market-based green finance concepts can play a supporting role in the sustainable transition, which is particularly important if first-best solutions remain politically unavailable. Although we see significant private and social costs associated with transparency-based green finance regulation, we conclude that mitigating climate change is a paramount objective for humankind and that the precautionary principal warrants pursuing such regulatory strategies, despite robust cost-benefit-analyses being unavailable.

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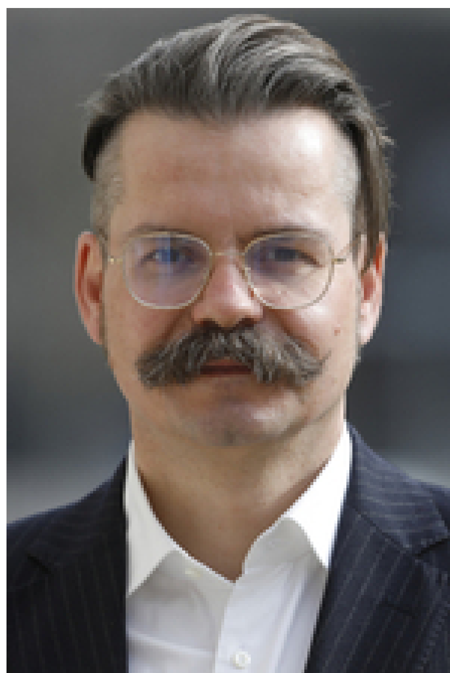

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