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## What the financial industry can do to help combat climate change

Jan Pieter Krahen: A simplified division into green and brown securities is insufficient. The financial market can and must play a broader role in the transformation



**S**lowing global warming is one of the most significant challenges of our time. Success will require massive investment in sustainable energy production and use and, ultimately, a change in some of our lifestyles. The financial sector is also under increasing pressure to contribute to this transformation towards a "green" economy. But what role can the financial system play? Can green investor preferences make a significant contribution, and to what extent does the success of the transformation depend on actual legislative work? The answers to these questions are highly controversial.

The fund industry, for example, has argued that the selective structuring of investor portfolios towards green companies can improve their financing conditions and, thus, their growth prospects compared to "brown" companies and therefore make an essential contribution to the transformation. From an economic point of view, however, this argument is countered by the fact that the composition of green securities in a portfolio is hardly suitable to influence their relative prices.

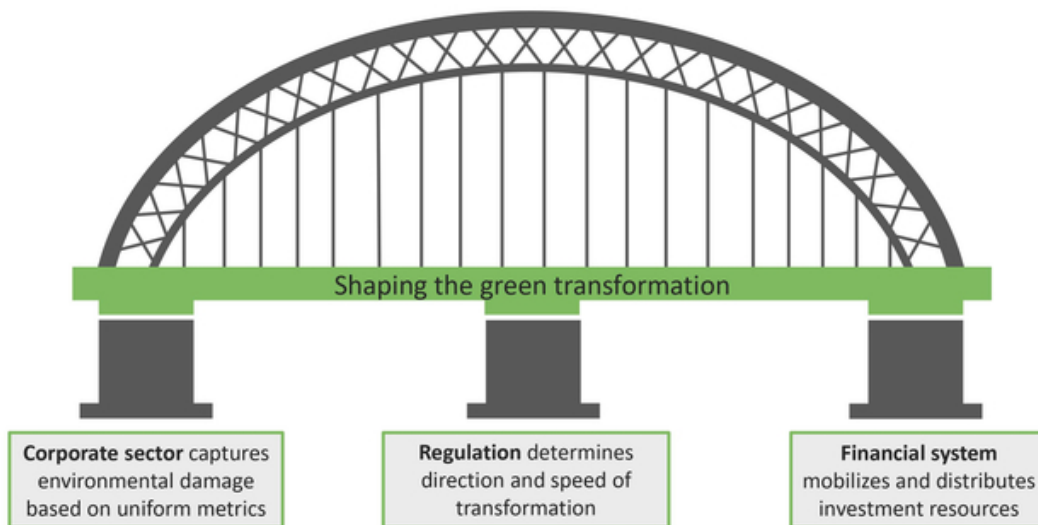
A liquid securities market typically ensures that shifts between investor portfolios do not affect prices. Even if excess demand for green securities and the expected return on these securities falls, this presupposes that investors will continue to be willing to accept a warm glow rather than a recurring dividend.

### Reliable metrics, measurement, and reporting need to be implemented

The problem is further complicated because the methods commonly used today to construct green portfolios for investors focus on something other than the change in climate-damaging emissions but instead on the level of those emissions. Measuring the change caused would require scientifically based metrics, comprehensively collected measurements, and a trustworthy reporting system – all of which still need to be implemented.

Finally, there is the problem of attribution: a direct link between a particular financing measure and an individual (green) investment decision is difficult to prove - and, therefore, essentially arbitrary.

The above criticisms suggest a regulatory role for finance, which is presented here as a bridge with three supporting pillars (see illustration). Pillar 1, Firms and Households, provides the data basis for tracking climate pollution at the firm and household levels. Pillar 2, policy, describes the regulatory framework with democratic legitimacy for firms and households to determine the direction and pace of transformation. Pillar 3, the financial system, mobilizes and distributes the necessary investment funds to firms and households.



The illustration depicts a regulatory role for finance as a bridge with three supporting pillars. Pillar 1, Firms and Households, provides the data basis for tracking climate pollution at the firm and household levels. Pillar 2, policy, describes the regulatory framework with democratic legitimacy for firms and households to determine the direction and pace of transformation. Pillar 3, the financial system, mobilizes and distributes the necessary investment funds to firms and households.

Regarding the fundamental tasks in Pillar 1, it is up to research in particular to ensure uniform measurement procedures at the level of companies and households, for example, regarding greenhouse gas emissions or the loss of biodiversity. Pillar 2 contains the politically determined and continuously updated framework for economic action – a basic regulatory orientation. For example, the government may set company-specific time and volume targets for achieving a net-zero emissions goal and require their disclosure.

With robust data on causal attribution of environmental damage and clear and long-term rules on climate-related limits for companies, the financial market, as the third pillar, can assess the impact of individual damage contributions on subsequent financial returns and risks – thus enabling the desired internalization of environmental externalities. These services of the financial sector are made possible not only by pricing listed companies on the capital market but also by setting conditions for bank loans and, thus, for small and medium-sized enterprises and households.

The regulatory framework determines the extent and speed of this transformation process, as it has a decisive influence on which activities can be profitable and which cannot. In this bridge of transformation, the role of government as a rule maker is crucial because it can provide democratic legitimacy for far-reaching interventions in market activity. The natural profit motive of companies will then also direct investment resources to areas where companies can achieve the regulatory limits most efficiently.

### Financial institutions and markets as a supporting pillar of the transformation process

The question posed at the beginning of this paper about the role of the financial system in the green transition can now be answered clearly: Financial institutions and markets should be seen as a supporting pillar of the transformation process, acting in complementarity with firms and households, which continuously provide data on environmental impacts, and also in complementarity with the political decision-making process, in which the regulatory rules for the direction and speed of the transformation process are set with democratic legitimacy.

This characterization of the role of the financial sector makes it clear that without reliable data, which is lacking today, and without a clear and stable policy framework, which is also lacking today because of the data deficit, the financial sector cannot make a meaningful contribution to climate transformation on its own - this is especially true for institutional investors, who build a green investment strategy on the simple distinction between “green” and “brown” companies.

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*Blog entries represent the authors' personal opinion and do not necessarily reflect the views of the Leibniz Institute for Financial Research SAFE or its staff.*

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