Leibniz Institute for Financial Research SAFE

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Green finance upside down

Limiting climate-damaging emissions is important and right – but this objective is not readily achievable via the publicly promoted green finance approach

Climate change is one of the greatest challenges of our time, requiring massive joint efforts by government, the private sector, the science community, and civil society. For some time now, researchers have been near unanimous in their assertion that a comprehensive, worldwide, and immediate change of course is needed, especially in the use of fossil fuels, in order to avoid global warming beyond the two-degree limit.

The financial sector has been under increasing pressure to play its part in this effort. Precisely because climate change is such a crucial issue for current and future generations, it is vital that the financial sector make the right decisions. Here, right means that green finance actually has the positive outcomes that investors hope it will have. Unfortunately, while many green finance activities may give investors a clear conscience or are suitable as marketing tools for suppliers, they do not lead to a reduction in emissions. Against this backdrop, the Scientific Advisory Board at the German Federal Ministry of Finance has looked into the decisive criteria as to whether and how green finance can actually have an impact on combating climate change.

We can only warn against premature and gullible enthusiasm for green finance – not because we doubt that a restriction of climate-damaging emissions is urgently needed, but because this cannot be easily achieved via the financial sphere. What is being sold today under the title of "green finance" is often not worth the money. There is virtually no causal link between the so-called green financing instruments and an actual use of green funds. Two examples illustrate this: one on green investment strategies, the other on green public debt.

Selling brown shares and buying green shares do not make the portfolio greener

Private investors, for example, are now offered sustainable or green portfolios by many fund companies, banks, and insurers. This promises to not only transform the economy, but to also increase returns. Sustainability is said to lead to a higher return in the long run – even for passive investors – than conventional or even "brown" investments. Unfortunately, the argument is incorrect.

The compilation of green stocks – that is, of companies that operate in an ecologically responsible manner – does not by itself lead to an actual change in production. A company can nominally divide its production into clean and dirty sub-processes. Formally then, some of the investors may have financed the green production processes and others the brown ones. But nothing has changed in terms of overall production – except that investors with strong environmental awareness may now have a clearer conscience. The same applies to the entire financial market.

If an investor sells a brown share and buys a green share in return, this does make their own portfolio greener. The aggregate emission of all companies has not changed. It is a characteristic of a globally integrated financial market that a redistribution of existing financial securities between investors in market equilibrium does not trigger any price effects. At most, from the green investor's point of view, a loss of diversification is to be expected.

Attributing green bonds to climate-friendly spending is sheer illusion

Green sovereign bonds have also been available to investors in Germany since September 2020. These green bonds are securities that are identical in every respect to conventional sovereign debt, except that they are juxtaposed with government expenditures that are labeled as green or ESG (environmental, social and corporate governance). If an investor purchases such a green bond, can they claim an impact on government investment behavior? The answer is no. Buying a green bond has the same effect as buying any government bond: it enables the government to take on debt and thus contributes to every budget line item. Directly allocating a particular bond to a specific budget item, such as a particularly climate-friendly spending item, is sheer illusion. In short, the revenue and expenditure sides of the government budget are not causally linked in the sense of individual balance sheet layers.

The two examples show that investors, who seem to like to follow green investment opportunities, in the vast majority of cases have no actual effect on the investment behavior of companies nor the state and thus not on the ecological constitution of the world. These considerations bring us to certain conclusions for investors who really want to make a difference and not settle for feel-good effects.

The main conclusion is that investors who want to effectively pursue a goal can only do so by assuming the role of an active investor. Shareholders must actively participate in the decision-making process at the corporate level, either personally or indirectly through their fund representatives. The prerequisite here, however, is the willingness to accept a permanently reduced return on capital employed, because steering a company's management in the direction of a greener or more socially responsible business policy is generally at the expense of the company's earnings.

An ecologically oriented investment policy is possible

The second conclusion is that investors who really want to make a difference should not base their investment decision on whether a company is currently green or brown. Instead, they should focus on the companies in which their activities can produce the greatest change from brown to green business policies. Because this change could ultimately lead to a reduction in emissions.

The third conclusion is that green government bonds will remain a pseudo-contribution to a "greener" society as long as the financing does not serve to vouch for greener politics. In the sense of the active investors described above, this would only be possible with extended rights of co-determination over the use of the state budget – in a democracy, however, these decisions are reserved for parliament. The influence of investors is out of the question, even with good intentions for climate protection.

Climate change is too important an issue to rely on seemingly simple solutions. In the corporate world, an ecologically oriented investment policy is possible. But it requires that investors extensively intervene in the business policies of companies. In the case of public finances, such investor influence is prohibited – for good, democratic reasons.

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