Olli Rehn: Climate change and green finance

Keynote speech by Mr Olli Rehn Governor of the Bank of Finland (at time of speaking Deputy Governor of the Bank of Finland), at the Finnish Climate Summit, Helsinki, 13 June 2018.

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Ladies and Gentlemen,

Many thanks for the invitation to this important event, the Finnish Climate Summit. Helsinki is in fact today fully tuned to the music of the future, i.e. key future policy issues, since the Bank of Finland is right now running a three-day conference on the subject "Money in the Digital Age" on the other side of the town. I am glad to "change the club" for a moment, not least as Sitra is originally a spin-off of the Bank of Finland, some half a century ago.

Already in 1987, the report of the World Commission on Environment and Development – known as the Brundtland Commission – defined the need for economic growth to be socially and environmentally sustainable. I am a proud owner of the first edition of that report. Already back then, key questions of sustainable development were much the same as today: how to balance its three pillars, i.e. economic, social and ecological development.

Today, it is widely recognized that climate change is a significant risk to economic growth and financial stability – and to the future of our planet. For instance, the World Economic Forum concluded in its annual Top-10 list of the biggest risks in terms of impact, that no less than eight of those risks are linked to climate change, one way or another.

That should not have been big news. The fundamental problem with climate change was described thus in the Stern Review in 2006: "*Climate change is the greatest and widest-ranging market failure ever seen.*" This is because climate change is an economic externality, meaning that whoever causes the emission does not pay the full costs of the damage.

Despite the significant political achievements, like the Paris Agreement and the Kyoto Protocol, global policy action still falls short of what is required. The withdrawal of the USA from climate action is of course detrimental. The EU is leading the global effort also in this field.

Mark Carney, Governor of the Bank of England, has referred to "the tragedy of the horizon": the impact of climate change is felt far in the future, while the costs are immediate, and thus we lack the right incentives to fix the problem. Economists might talk about 'time inconsistency'.

That compels us to ask some fundamental questions on policy. If carbon is the problem, why not just ban it or strictly limit its emission?

The reason is that for the past couple of centuries, economic growth has also implied equivalent growth in the emissions of CO^2. And historically, economic growth has gone hand in hand with the increase in welfare.

Thus, by limiting carbon emissions without any structural change we would also limit the welfare of our citizens. Instead, we need to figure out how to continue enabling our economies grow, while at the same time effectively cutting down our emissions. Some countries have already managed to weaken the link between economic growth and emissions, but for the future of our planet, the link needs to be cut across the world.

The transition of our economies to sustainability requires a lot of capital. The European Commission has estimated that, in the EU, there is a gap of 180 billion euros a year in investments to support the transition.

And every year when this gap is not closed, it accumulates. Let’s call this **the climate debt.** And it needs to be paid back at some point. For us not to become over-indebted, we urgently need to start filling the gap.

In the Commission’s action plan, prudential regulation aims at providing incentives for green finance. This would imply e.g. that risk weights for green investments in banks’ capital requirements would be lower – relative to ‘brown’ or environmentally damaging activities.

However, a word of caution is in order. Green investments are not without normal financial risks either, and these risks cannot be disregarded without jeopardizing financial stability. The previous financial crisis pushed climate policy discussions into the political background for a decade. Let’s not repeat that. So, financial stability needs to be at the heart of environmental finance, because it also must be economically and socially sustainable – let’s not forget the lasting wisdom of the Brundtland Commission!

The central banks in the Eurosystem are keenly aware of the problem posed by climate change, and understand that the environmental goals of the EU belong to the objectives that the treaty obliges the central banks to support – without compromising the goal of price stability. At the same time, we understand that it is primarily the responsibility of the political authorities to decide on the appropriate public policy measures to achieve these goals.

Correct pricing and supervision of financial risks stemming from climate change (and other environmental hazards) are needed, both for sustainable economic development and for a well-functioning financial system. The central banks in Europe support the ongoing work in various international fora for removing the obstacles holding back green finance, for better disclosure of climate-related risks, and for better integration of risk management and regulatory frameworks to environmental assessments.

In concrete terms, sustainability considerations should be better reflected in the key tools for decision-making by market actors and policymakers, such as benchmarks and credit ratings. At the same time, we must take care that changes to regulatory frameworks are justified from a prudential perspective and do not undermine their own original purpose.

In financial regulation, environmental risks are increasingly relevant. Insurance is a case in point. Insurers have already started paying for climate change. Insurers’ risk models need to adjust to the increasing frequency and severity of the extreme weather events.

Thus, the insurance industry clearly has incentives to be part of thesolution. But exactly the same applies for the banking industry as well, and in financial regulation and management we should take into account not just the risks that the investment projects themselves are vulnerable to, but also the risks which any ‘brown’ or unsustainable projects may cause to the economy.

Talking about environmental finance, the most direct way to influence the flow of funds is to use semi-public institutions, like the European Investment Bank, multilateral development banks, and other similar organizations for the purpose. With them, the right incentive structure for private money can be created without overburdening the public finances. After all, such institutions are already active in the field, and further involvement could be encouraged.

The European Fund for Strategic Investments (EFSI) is a prime example. Its extended version, EFSI 2.0, has a mandate to invest at least 40% of its 500 billion euros capacity in green investments. Such investments can be leveraged with private capital for an even bigger impact. Private money, and more importantly private investment decisions made by private companies, need to be aligned with the sustainability targets.

Economic theory suggests that the first consideration of policy should be to remove wrong incentives and replace them with better ones, which would take into account the environmental externalities of different economic activities. No longer should the polluting companies freeride on the backs of others – we need to move towards the principle of ‘the polluter pays’.

The International Energy Agency has estimated that global fossil-fuel subsidies exceeded EUR 250 billion in 2016. This is a direct subsidy for fossil fuel consumption at a time when we have problems in finding out how to pay for the transition to sustainable energy. This balance must be changed.

Ending fossil fuel subsidies is only the first step. As a second step, we need to incorporate the costs of emissions into the decision-making processes of every company. Fixing the EU Emissions Trading System or introducing a global carbon tax should help solve this externality problem.

The third step is to increase transparency in companies’ business models by requiring them to disclose their emissions. The Commission and the Financial Stability Board have been working on such reporting. Many large institutional investors have already embraced their recommendations.

As I have argued, there is much that can be done in the financial sector to promote sustainable development. However, there is no single ‘silver bullet’ that would solve the problems of environmental finance at a stroke. Rather, it will take a lot of careful and detailed work, going through our regulatory systems and financial management frameworks, to build a more environmentally friendly and solid financial system.

At the Bank of Finland we want to play our part, too. We have recently decided to apply responsible investment standards to the management of our investment portfolio. We will also be a member in the newly created Central Banks and Supervisors Network for Greening the Financial System, which is an important forum to discuss climate action with the financial sector.

Finally, everybody needs to be part of the change. Hence, I call on both private companies and public institutions to work for sustainable development – and for sustainable finance – with the economically and socially effective means at their disposal.

Thank you very much for your attention.