Restoring environmental capital markets

Unlocking the potential of capital markets will be pivotal to fund the climate transformation. Although early phases of market formation have been promising, setbacks have been experienced. As such, market mechanisms have been damaged – key markets have been shrinking or face disproportional growth projections.

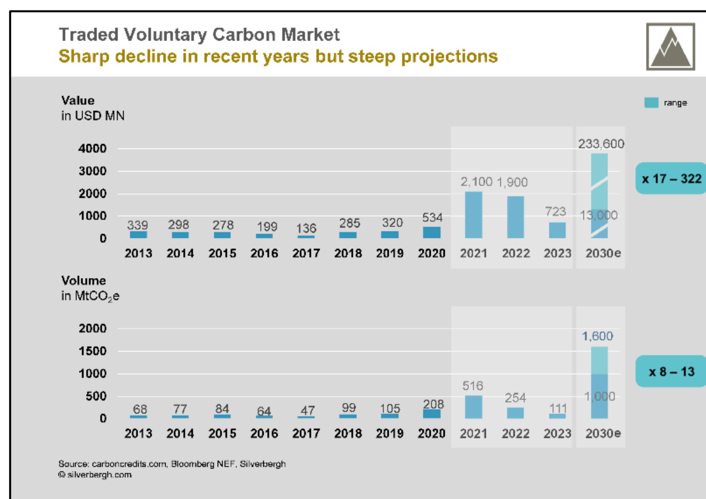
Recognizing initial design flaws would allow to regain trust. As a result, inflow of funds would be stimulated. Business opportunities would evolve and the prospects to cope with the climate crisis would improve.

Environmental markets can unlock capital for climate transformation

Environmental markets have been formed some years ago and have exhibited gradual growth with at times some corrections. There has been a constant debate on market design, characteristics of the traded underlying (product) and the investability/ bankability of new environmental asset classes as well as the roles of different market participants.

In the spotlight of the debate are two key markets

- **Voluntary Carbon Market (VCM)** in which carbon offsets are being traded[1]
- **Markets for ESG investments** as defined by the respective issuers[2]
- …



We do not intend to repeat arguments already made e.g. the role and relevance of rating agencies and indices, portfolio composition, investment focus – status quo vs. change, credibility of measurement and assurance mechanisms, controls, conflicts of interest, self-regulation vs. government regulation … . Neither do we try to be complete and exhaustive.

Instead, it is time to reflect and identify whether adjustments are needed.

After the heydays, the market mechanism has been damaged

For both markets, the 2019-2022 period has been very successful. Both markets have grown significantly and have gained an increasing role in investment and public policy frameworks and debates. As of 2022, investors (and customers) have increasingly questioned market integrity and promises made. In both markets there are doubts whether the climate/ sustainability performance of the respective asset classes will live up to expectations.

Additionally, the …

- **VCM** markets and purchases of offsets will not relief the buyer from decarbonizing his value chain to meet net zero commitments
- **ESG investment markets** may not necessarily provide superior performance, nor will they necessarily mitigate long-term risks.[3] In the majority of ESG

[1] For this debate we stick to overall market trends and do not discuss individual segments or compliance markets

[2] And as classified by the Global Sustainable Investment Alliance (GSIA); investments include environmental considerations but might have a bias towards other ESG dimensions, the 'S' and/or the 'G'

[3] Le Sourd, Does ESG investing improve risk-adjusted performance?, Nice, 2023

portfolios, giant tech stocks have been a driver of financial performance.[4]

As a consequence, institutional investors are increasingly hesitant when considering exposure. In the VCM, investors more often turn a blind eye on Nature Based Solutions (NBS) but favor Engineered Solutions (ES). Whether these investments will in the end be successful is highly questionable given their high CO_2e abatement costs.

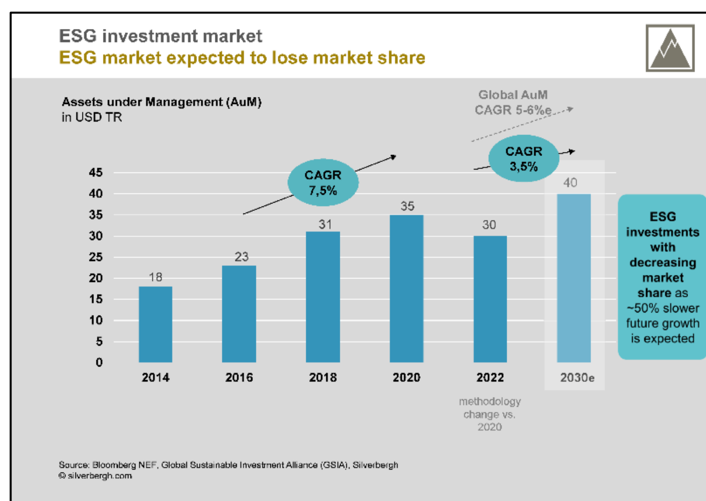
Damaged market mechnism

As a matter of principle, the more accurately a good or an asset class can be defined, the better it can be assessed by buyers and investors. This is key for price discovery. As a result, high quality markets will gain liquidity meaning the market size will grow as purchases/ investments will be facilitated.[5]

On the contrary, if the value of an asset is not clear, the market will assign discounts to the asset. Not being able to define climate performance or risk adjusted financial performance would be reasons to assign discounts. Also, a lack of binding valuation practices and synchronization to financial calendars of companies/ investors would be a burden to determine the intrinsic value of the asset. It also raises a set of additional technical issues which need to be addressed.[6]

In the VCM, the contribution of instruments traded to climate performance has not been clear mainly due to simulation-based product design and multiyear true-up mechanisms.[7] As such this raises accounting challenges and hurdles to synchronize this asset class with financial calendars. Additionally, the lack of quality prohibits the evolution of financial markets (cash settled instruments based on the physical underlying).

In ESG investment markets, portfolio construction relies very much on ESG ratings provided by agencies. Conceptually, this is associated with some challenges. Different ESG indices are not correlated and consequently do not lead to the same outcome.[8] ESG ratings are based on scoring approaches integrating and weighting a set of parameters meant to capture environmental, social and governance aspects of the company. The capital allocation outcome of these portfolios is not entirely clear.



If for example the investor is in favour of contributing to reducing climate warming, he might want to invest into a portfolio which reflects the traceable reduction of greenhouse gases (GHG) linked to financial performance. Any other indicator would be a delusion to his investment objective. Investing into a status quo would favour low carbon businesses but might not be as effective to contribute to GHG reductions. Hence, investing into any ESG portfolio may not be the most efficient way to allocate capital.

Other investment objectives – e.g. on the 'S' and 'G' dimensions - could be dealt with by introducing exclusions or hurdles outside a weighted set of parameters.

The implications from the above observations are substantial:

- Inefficient allocation of capital, disincentive for 'climate investors',
- Lack of price discovery and risk management approaches,
- Limitations of instruments for GHG reductions available to companies,
- Lost opportunity for asset managers,
- …

Equity, debts and mature commodity markets have experienced an evolution leading towards liquid and credible markets today. This took years or even decades. Although this knowledge exists, it is astonishing that market participants and institutions do not 'pivot' sufficiently facilitating markets to recover going back to their earlier growth trajectory.

[4] Silicon Valley buoys ESG funds, Financial Times, London, 12 July 2024
[5] Assuming that demand exists
[6] Accounting for Carbon Credits, International Swaps and Derivatives Association (ISDA), New York, 2023
[7] Probst et al, Systematic review of the actual emissions reductions of carbon offset projects across all major sectors, Zurich, 2023
[8] Berger et al, Aggregate Confusion: The Divergence of ESG Ratings, Zurich, 2022

If the conditions would be different, we could sit back and observe. However, as societies we are working against a shrinking 'GHG budget' to keep global warming below 2 ˚C, we have no time to waste. We simply cannot afford to 'take capital markets out of the equation'. We need more capital markets to unleash capital funding the climate transformation. Therefore, credibility in existing markets needs to be re-established paving the way for more environmental capital market activity.

Fixes and innovations

Two approaches might be followed entailing a set of activities (examples).

First, fixes need to be applied to existing markets as indicated above. If market participants want to avoid regulatory intervention, they are well advised addressing today´s deficiencies. Even though financial market regulators have been holding back, environmental markets are on their radar screen.[9]

Second, there are ample of opportunities for environmental product and market infrastructure innovations.

- **In the VCM,** participants would benefit from credible markets for carbon offsets and deeper financial markets linked to high quality underlyings. This market is fundamentally broken today.[10] Activities of market participants – especially the supply side - do not provide sufficient evidence for optimism. Their ability to fix the remaining issues without regulatory intervention seems to be limited. However, there is awareness that accounting practices need to be amended as a basis for regaining credibility.[11]

  Additionally, companies who have committed to a net zero journey cannot rely completely on offsets but must reduce GHG emissions within their (own) value chain and adjacent value chains. Although they can reduce their financing cost through environmental debt instruments already today, creating a market for bankable 'GHG in-setting' could be a new perimeter of asset classes accelerating the journey to net zero.

- **In ESG investment markets**, linking portfolios more **stringently** to improvements on the ESG dimensions might attract additional capital. Carbon accounting would need to be upgraded, new indices and benchmarks would be required. Biodiversity as an upcoming ESG theme is not widely reflected yet in investment approaches but a demand-pull for portfolios integrating this rationale prominently can be expected.

  ESG investment markets have in the past adapted to changing requirements – sometimes with regulatory influence. If awareness is turned into action, markets should be able to provide more targeted quality environmental investment products soon.

  EU CSRD regulation and taxonomy also provides a new type of infrastructure and data which could be instrumental for environmental capital market innovations.

Summary and outlook

The inception of environmental markets has been promising. However, the recent years have revealed deficiencies in market mechanisms at work in environmental capital markets. This is a limiting factor for climate performance and financial prosperity as it limits access to funding and capital market growth.

Now is time to 'pivot' – fix existing deficiencies and introduce financial product and market innovations. A collaborative approach between market participants can speed up the process and adoption of capital market frameworks.

There is a lot to lose BUT also a lot to gain!

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[9] SEC, The Enhancement and Standardization of Climate-Related Disclosures for Investors, S7-10-22, Washington D.C., 6 March 2024

[10] Prices have not bottomed out yet decreasing from USD 21.28 (Jan 2022) down to USD 1.85 (Jan 2024) and USD 0.23 (Sep 2024) for CBL Nature-Based Global Emissions Offset Futures on NYMEX

[11] Kaplan et al, Accounting for carbon offsets –Establishing the foundation for carbon-trading markets, Harvard Business School, Boston, 2023