Wake up and smell the carbon

__Christopher Huhne__ makes the case for greater low-carbon investment and says the financial sector needs to be more aware of the risks of climate change

There has never been a phenomenon quite like sustainable finance. In the past, there have been ethical campaigns designed to highlight the arms trade, apartheid or tobacco, but none has taken off with quite the momentum of sustainable finance and, in particular, low-carbon investment.

In 2016, there was $23tn of professionally managed, sustainable investments, up 25 per cent in two years. Taking a wider definition, funds that have signed up to the UN Principles of Responsible Investment now total $60tn. This impetus for low-carbon investment is not just ethical: it is also about avoiding losses in a world where global warming is manifest. The combination of high-mindedness with rather less exalted self-interest is unbeatable.

Although there have been equity (and debt) losses in the failures of some coal companies, equity investors have another reason for action. There have now been four studies suggesting low-carbon companies outperform. In the case of the Engaged Tracking low-carbon index, the outperformance of the global index (ACWI) since 2012 is 1.44 per cent a year while cutting carbon exposure by 72 per cent. This may reflect better managements that can see the next set of problems, or the demand-side trend to low-carbon investing. Low carbon companies may also be less at risk from new technology: electricity generation from wind and solar is now cheaper than gas. Whatever the reasons, it seems that low-carbon equity investors can cut risks and maintain or increase their returns.

Nor are populist rebellions likely to affect the trend. Donald Trump, the US president, will slow, but not reverse, the global effort to reduce carbon emissions. As gas displaced coal, and solar and wind displaced gas, US greenhouse gas emissions fell 2 per cent in 2016. They will probably continue to decline, despite the evisceration of the US Environmental Protection Agency (EPA). New technology and the US states' efforts count for more.

There are also increasingly strong legal and regulatory incentives for backing sustainable finance. Mark Carney, governor of the Bank of England, has highlighted the risks from climate change. Legal opinions warn about the liabilities of trustees who fail to perform their fiduciary duty in respect of environmental risk. Woe betide the Aramco prospectus writer – if the IPO ever happens – who fails to flag up climate change's potential to destroy the value of oil reserves.

Yet many institutions are guilty of "greenwash" – signing up to grandiloquent chief executive declarations of virtue, but in reality failing to change the operation of their businesses. It is true that data failings continue, although there are both modelling and rule-of-thumb ways around those. But too many risk officers are still grappling with how to assess climate risk in numbers. The gap between intention and reality needs to be closed.

For example, both rating agencies and bank risk officers ought to be able to stress-test their portfolio of bonds and debt against not just fossil fuel prices but also carbon prices. The Engaged Tracking model shows that a $56 carbon price – the figure that the pre-Trump EPA thought would be necessary to drive sustainable global emissions – would wipe out 69 per cent of the earnings of the S&P 500. It is not hard to imagine a higher carbon price that has exhausted the equity cushion and eaten into the potential for debt service.

> "Trump will slow, but not reverse, the global effort to reduce carbon emissions

A sharp rise in the carbon price – or even a regulatory clampdown on high-emission products and services – is not fanciful. Changes in environmental policy rarely happen smoothly and predictably: look at the UK Clean Air Act 1956 following the killer London smogs. A glacier slide from Greenland or Antarctica raising sea levels, devastating storms, or the release of sub-soil methane from warming tundra are all the sort of cataclysmic events that could trigger a sudden and panicky recognition of what science has been telling us.

As terrorism shows, people react quickly and urgently to threats they can visualise. Yet, at present, the financial sector is still slumbering. It is wake-up time. ■

__Christopher Huhne__, formerly UK energy and climate change secretary and a former head of sovereign risk at Fitch Ratings, is a consultant. He is an investor in Engaged Tracking