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Briefing Paper 2

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Lessons learned from the financial crisis - A cautionary tale for the Green Climate Fund

By Friends of the Earth US

As policymakers and civil society organizations debate the design, purpose and modalities of the Green Climate Fund (GCF), they should closely consider some key lessons of the financial crisis. This issue brief provides a short recap of the beginnings of the crisis, and then applies key lessons to the GCF.

Since the financial crisis, it has become clear that capital markets have become extremely complex, interconnected and financialised. In the past, a home mortgage was a matter between a local bank and a homeowner. Not anymore. In 2008, the world saw how a housing bubble in the US had massive effects, triggering a banking meltdown, a global recession, and fiscal calamity in many countries. According to many scholars, even the current euro zone crisis is not so much a problem of sovereign over-borrowing as it is a continuation of the 2008 financial crisis, which is now laying bare the structural weaknesses of the European monetary union and its fragile banks.

I. A short story of the financial crisis

Conventional wisdom holds that the financial crisis was the fault of irresponsible consumers in the US who borrowed more than they could afford. Although that undoubtedly was one aspect of the problem, there was a deeper driver: after the US lowered interest rates after September 11, 2001, it not only made borrowing very cheap, it reduced bond yields, which caused institutional investors, such as pension funds, hedge funds, insurance companies and sovereign wealth funds, in the **capital markets** to seek new investments.

To meet this demand, Wall Street bankers - through **"financial innovation"** - produced mortgage-backed securities (MBS). This new financial instrument bundled together thousands of home loans and sold them to investors around the world. These became so popular that financial intermediaries started underwriting more and more of these securities to satisfy what seemed like an unending appetite for these products. Wall Street played an enormous role in inflating the housing bubble; as too much investment money chased too few good assets, homes became dangerously overvalued and it spurred the build-up of bad assets.

This build up of bad assets was made possible by a **misalignment of incentives,** which led to recklessness throughout the value chain. Mortgage brokers falsified loan applications, banks ignored lending standards, underwriters created risky securities that no one could understand, credit rating agencies provided faulty advice, and insurance companies overpromised on credit default swaps. The allure of short-term profits -- especially when someone else had to take the risk -- made it easy for everyone involved to turn a blind eye.

Of course, **poor financial regulation** – in no small part due to Wall Street's influence over the US Congress - was a critical factor as well. Financial regulators failed to supervise the massive growth of the shadow banking sector. Financial entities such as hedge funds, special purpose investment vehicles, private equity firms, and others operated under very little regulation. Many employed very risky strategies, for example, using short-term borrowing to invest in longer-term investments, or speculating in the unregulated over-the-counter derivatives markets.

II. Lessons from the financial crisis – and its application to climate finance

Many analysts and financial regulators understand that the US housing market did not cause the financial crisis, but simply sparked it. Instead, drivers such as financialisation, misaligned incentives, and poor regulation were the real culprits, and unless regulators address these underlying problems, policymakers will face similar crises in the future.

In this sense, it is important for the GCF to closely consider how similar dynamics may impact the integrity and efficacy of climate finance, which should be treated as a global public good.

The tyranny of the markets

Globally, institutional investors, manage some $90 trillion in assets. Underwriting, asset management, and other services for institutional investors are a lucrative Wall Street business, and this "giant pool of money" is seen as the source of capital to fund everything from home mortgages, to corporate expansion, to government borrowing.

Institutional investors are also being viewed as the source to "leverage" climate finance. For example, the GCF could raise money from institutional investors by issuing bonds. Or the GCF could transfer money to fund managers, and require them to find matching funds. **Whether institutional investors help capitalize the GCF or disburse GCF funding, their involvement will likely require a commercial rate of return at the very least. Some investors, such as certain hedge funds, seek much more than commercial rates, they seek profit maximization.**

Allowing commercial interests to guide GCF financing decisions would likely mean that non- or low-revenue generating activities, such as most adaptation efforts, would get short shrift. It would also mean that the very poorest countries, which currently do not attract private finance, would continue to be bypassed. After all, it is likely that a pension fund would put money into an Emerging Asia power fund, but not very likely that they will fund a program to resettle climate refugees.

"Financial innovation" – and the dangers

Financial innovation can be a good thing, but as Lord Taylor of the UK Financial Services Authority has pointed out, it also "has produced some products of very dubious social value." In the run-up to the financial crisis, financial innovation "became over complicated, we had securitisation and re-securitisation, we had the over development of the credit-derivatives swaps market— somehow we just created this empire of activity."[i]

A climate fund of some $100 billion per year could very well attract an empire of activity as Wall Street firms seek to access or manage GCF funds. But outsourcing GCF funding decisions to the financial markets creates the risk that financial engineers may create inappropriate and ultimately ineffective financing structures to "deliver" climate finance. Perhaps the best example of this in current practice can be found in the international carbon markets.

The Clean Development Mechanism (CDM) should be viewed as a prime example of how inefficient carbon markets can be for funding projects in developing countries. One study found that only about 31 per cent of total funds received for CDM credits capitalize mitigation projects, with the rest going to carbon traders and middlemen.[ii] In forest offset projects, intermediaries often capture even more, over 50 per cent of REDD financing.[iii] (Moreover, in any case, since carbon credits are used to offset developed country emissions, they should not be considered as climate finance.)

Misalignment of incentives

The 2008 financial crisis was characterized by a massive misalignment of incentives and, in many cases, pure conflicts of interest. But there are countless other examples of how the motivations of short-term capital have clashed with the interests of those in the real economy, particularly with those looking to protect or promote the public interest. In the 1990s, speculators' rent-seeking behavior crashed Asian economies with hot money flows, and undermined governments. Ten years later, derivatives traders flooded agricultural commodities markets, pushing up food prices and introducing volatility for farmers and buyers. Shareholders' pursuit of short-term profit has long prevented responsibly-minded corporations from considering long-term sustainability.

If the Green Climate Fund allows too many decisions and priorities to be set by capital markets, this would create a gross misalignment of interests and undercut key UNFCCC policy goals, such as providing developing countries with adaptation funds, and ensuring that "particularly vulnerable" areas receive priority.

A Green Climate Fund bent on "leveraging" private capital, as some negotiators are advocating, is certain to attract financial engineers with more experience in intermediation than in ensuring climate effectiveness in developing countries. In the worst cases, this can result in the creation of risky products and services that are not only irresponsible from a fiduciary perspective, but also may take away resources from worthy and effective adaptation and mitigation efforts.

Over-excitement about leveraging the private sector has pervaded the discourse on climate finance. Many questions remain as to what extent public money has actually leveraged private finance and whether such investment would have happened anyways. As the Overseas Development Institute notes, "Increased transparency in the use of international public finance would elucidate the current and potential role of public finance in leveraging private finance, and would increase understanding of the effectiveness and success rates of such efforts. Metrics to measure leverage and to count the impact of public sector finance in leveraging private capital need to be developed and agreed (AGF, 2010)."[iv]

One key strategy used to leverage private capital is the development of risk sharing or risk reduction instruments, such as loan guarantees or political risk insurance (in some countries). While risk sharing products can be valuable and legitimate in some cases, they always carry the danger of misaligning incentives and creating moral hazard. They may have the perverse effect of weakening due diligence processes and stimulating investment in unsuccessful projects that fail to mitigate greenhouse gas emissions or provide genuine adaptation benefits. Certain risk sharing instruments could also give rise to accusations that climate funds serve to privatize profits, while letting the public shoulder financial losses, making communities bear the brunt of any environmental or social harms.

Weak regulations

Finally, a massive failure in financial regulation played a major role in the financial crisis. Unfortunately, in the last few years, efforts to reform the financial sector and bring more of it under regulatory scrutiny have been lacking, particularly at the international level.

Therefore, the GCF should strive to uphold the highest standards in good financial governance, and, at the very least, refrain from practices that frustrate financial regulation. Areas of particular concern include the unregulated over-the-counter derivatives market, the proliferation of offshore tax and secrecy jurisdictions, and the persistent lack of transparency that characterizes much of the financial sector, particularly non-bank financial institutions.

For example, asset managers such as hedge funds and private equity funds still operate as part of the "shadow banking sector." Unless they are willing to be subject to financial regulation; subordinated to developing country government priorities, strategies and requirements; and wiling and able to implement environmental and social safeguard standards, these shadow banking institutions should not be involved in GCF financing. Similarly, the GCF fund should not be involved in risky, unregulated derivatives.

III. Recommendations

In light of these lessons learned, the GCF should approach the private sector with a high degree of caution. In particular, the GCF:

- Should not establish a private sector facility that would allow corporations and financiers to have direct access to GCF funds. Rather, the role of the private sector in the GCF must be decided, managed, regulated and incentivized at the national and sub-national level in line with countries' preferences and needs and in accordance with robust safeguards.
- The GCF should only engage private finance to the extent that private financiers can guarantee the implementation of robust due diligence processes designed to address financial, social, and environmental risks, and produce effective mitigation and adaptation outcomes.
- Since the purpose of climate finance is *not* to help Annex I countries meet their own mitigation obligations, no GCF funds should be used to finance carbon offset projects.
- The GCF should uphold best practices in financial oversight and governance practices, including, but not limited to, prohibiting the use of tax havens for all GCF-related investments and financing.

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[i] Interview with Adair Turner, 29 August 2011 in *The Prospect,* at http://www.prospectmagazine.co.uk/2009/08/how-to-tame-global-finance/

[ii] The efficiency of carbon offsetting through the Clean Development Mechanism, Carbon Retirement, *2009.*

[iii] Corbera et al., 2009; as quoted in Hajek, F., et al. (2011): Regime-building for REDD+: Evidence from a cluster of local initia*tives in south-eastern Peru. Environ. Sci. Policy doi:10.1016/j.envsci.2010.12.007*

[iv] Brown, J. and Jacobs, M., Overseas Development Institute, Leveraging private investment: The role of public sector climate finance, April 2011, at http:/www.odi.org.uk/resources/download/5701.pdf.