

Using finance to green the planet

Why sustainable finance must follow, not lead, real climate action

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Governments, financial market regulators, and civil society organisations increasingly view financial markets as the key to achieving a greener planet. This rests on the premise that investors prioritise public interest over their private gains, aligning capital flows with sustainability goals. While finance certainly has a role, it cannot be the fulcrum of climate action for several reasons.

Financial markets operate on a risk-return calculus. They allocate resources among competing businesses based on risk-adjusted returns, which, in turn, reflect prices in product markets, and those prices reflect consumer choices. If a business, say a coal-based enterprise, is profitable based on prevailing demand and supply, it will attract investment unless there is a regulatory constraint or an economic disincentive. Expecting investors to routinely disregard prices, returns, and risks is wishful thinking. This is akin to expecting consumers not to buy Chinese goods while allowing their widespread sale. That is neither how finance works nor how markets function.

Markets reflect choices; they don't define them. It is policy and regulation that establish the boundaries of permissible conduct and determine what gets produced and consumed, how, and how much. A more effective and honest strategy, therefore, is to discourage or disallow harmful businesses at the source rather than hope markets will voluntarily avoid them. Adoption of electric vehicles did not happen because investors wanted to invest in these enterprises, but because of incentives and disincentives that influenced the choice of consumers and producers.

Environmental harm is perhaps the most severe and pervasive negative externality, where polluters do not bear the full ecological cost of their actions, and consumers typically pay only the private cost, not the broader environmental damage. The textbook remedy is simple: Price the externality. Make both the producer and the consumer pay the full ecological cost at the point of production and consumption. In the earlier decades, project appraisals often incorpor-

ated shadow pricing to account for environmental and social costs, not captured by market prices. Embedding such costs into pricing can correct distorted incentives and align market behaviour with sustainability goals.

This is entirely feasible within a market economy. When the full cost of dirty goods is reflected in prices, their consumption declines, profitability falls, production contracts, and demand for finance diminishes organically. In other words, full-cost pricing makes it unviable to consume or produce dirty goods, and, therefore, unviable to finance them. Capital stops flowing to unsustainable businesses, not because markets are virtuous, but because they respond to price signals. Therefore, full-cost pricing must precede, not follow, financial allocation.

There are inherent limitations to relying solely on finance to drive the green transition. First, finance influences the future more than the present. Sustainable finance tends to direct new capital into green businesses, helping shape tomorrow's economy. But it does little to reform the economy of today, which continues to rely on polluting industries. These industries operate with sunk investments and internal accruals. Simply withholding new

funding will not shut them down, nor can we expect consumers to stop buying products from these entities overnight. At the same time, green businesses, facing high upfront costs, will struggle to compete with legacy firms that bear no ecological burden. Unless we confront the entrenched, polluting industries (brown stock) and not just promote green investments, we risk creating a future that is green in patches, coexisting with a polluting present.

Second, firms are not monoliths, they are portfolios. A large conglomerate might run a coal plant, a solar energy division, a water purification unit, and a consumer goods business, all under one roof. One firm may produce both tobacco and asthma inhalers, while another produces diesel and electric vehicles. Some products have consumption externalities

depending on their end use. For example, energy and chemicals can be used in ways that are either environmentally beneficial or harmful. How does an investor fund only the "clean" part or ensure that a product is used for benign purposes? Markets invest in firms, not in business units. This bundling problem exposes a serious limitation in market-led sustainability efforts. Disentangling and ring-fencing business units at the capital allocation level is difficult. Market instruments are too blunt for this level of precision.

This is not to say financial markets have no role. They are highly effective at discovering prices, both positive and negative, for products, whether benign or harmful. They can help price and trade pollution, through instruments like carbon credits. A cap-and-trade system imposes a cap on total emissions and lets firms trade emission rights. It serves three important purposes: (a) creates a price for pollution, internalising the externality; (b) preserves flexibility, letting firms choose how to comply; and (c) incentivises innovation, rewarding those who exceed targets. There are other market-based instruments, such as renewable energy certificates, water usage rights, and biodiversity offsets, that operate on the same logic.

Financial markets excel in information symmetry. Voluntary environmental disclosures could be inadequate. What is needed is mandatory, standardised, credible reporting of environmental impact, just as we have for financial statements for listed entities. Only with such transparency can investors and consumers make informed, sustainability-aligned decisions.

Finance is not only a tool in the fight against climate change, it is also vulnerable to its effects. Climate disasters such as floods, storms, and extreme heat cause measurable economic and financial losses. Some of them shake the foundations of financial stability. Some sectors, like telecom, suffer disproportionately due to physical damage to cell towers and networks from cyclones. Yet, most financial markets have not adequately priced in these risks, beyond cosmetic insurance. Disclosures must capture firms' exposure to climate risks. They should also include scenario analysis and stress testing, especially for vulnerable sectors. Making the finance climate-resilient is as important as making it climate-friendly.

We must not expect markets to solve problems that only policy can. For a genuine green transformation, we must disallow or restrict harmful activities at the source; price environmental externalities fully and transparently; and mandate robust environmental disclosure. Within these policy boundaries, financial markets can allocate capital efficiently in support of a green economy. Sustainable finance works only when it is grounded in sustainable economics. Without this foundation, it risks becoming little more than the rebranding of conventional finance with a green label, a practice euphemistically known as greenwashing.



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