

An aerial photograph of a dense forest, likely a coniferous forest, with a river or stream winding through the center. The trees are a vibrant green, and the water is a light brownish-green. The perspective is from directly above, looking down on the forest canopy.

# Green Finance and Climate Policies in Canada and Germany

**By Kurt Hübner, Political Science Department, UBC  
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### Participating Webinar Speakers

**Caroline Flammer**, Professor of International and Public Affairs and of Climate, School of International and Public Affairs (SIPA) & Columbia, Climate School; Director, Sustainable Investing Research Initiative ([SIRI](#)), Columbia University; President, Alliance for Research on Corporate Sustainability ([ARCS](#)); Chair, United Nations' Principles for Responsible Investment ([PRI](#)), Academic Advisory Committee

**Dr. Nikolai Badenhoop**, legal scholar currently at Leibniz Institute for Financial Research SAFE in Frankfurt, Germany;

**Ryan Riordan**, Associate Professor & Distinguished Professor of Finance at Smith School of Business, Queen's University in Canada

**Dr. Marlen Vesper-Gräske**, attorney at Freshfields Bruckhaus Deringer in Berlin, Germany

**Gregor Weiss**, Professor of Finance and Chair in Sustainable Finance & Banking at Leipzig University, Germany

**Dr. Lucia Alessi**, Team Leader at the Joint Research Center of the European Commission, Milan, Italy

**Annica Coch**, Senior Advisor of the Finance Program at Adelphi, Berlin

**Sebastian Mack**, Policy Fellow for European Financial Market at the Jacques Delors Center of the Hertie School in Berlin

**Marla Orenstein**, Director of the Natural Resources Center of Canada, Canada West Foundation, Edmonton, Canada

## **GREEN FINANCE: What is it all about?**

***"Achieving climate neutrality requires as much political will as investments. We need the financial sector on board."***

**Ursula von der Leyen**

The transition to a net zero carbon emission economy requires the willingness of governments for far-reaching political interventions that result in a radical path change. It also involves the participation of the private business sector, not least because moving away from brown activities and into green activities comes with direct and indirect costs which need to be financed. According to a [report](#) by McKinsey, capital investment between 2021 and 2050 would amount to about USD 275 trillion, i.e. about USD 9.2 trillion per year. Financial markets play a critical role in reallocating resources to low and zero-carbon emissions, and so does the structure and functioning of the financial industry. Green finance has become a critical element of climate policies due to its potential function to mobilize money and capital for the transition processes. Two instruments are most prominent: Green Bonds and ESG investments. (i) A *Green Bond* is a type of financial instrument for borrowing money to invest in climate-friendly activities. Issuers of green bonds can be governments, supranational organizations, or the private business sectors. (ii) ESG investments consider

environmental, social and governance factors when it comes to investing decisions.

Policymakers and financial industry representatives praised Green Bonds and ESG investments as ultimate tools to support climate policies and accelerate the transition towards zero carbon emission economies. Simultaneously, critics expressed concerns that both instruments would be nothing



more than a greenwashing exercise where investors marketize the green label without seriously contributing to climate policies.

Moreover, political administrations in the US recently started actions against financial institutions which engage in ESG-guided investment strategies. On the forefront is the state of Texas with the publication of a list of institutions which are threatened to get fined with the [argument](#) that 'The environmental, social and corporate governance (ESG) movement has produced an opaque and perverse system in which some financial companies no longer make decisions in the best interest of their shareholders or their clients, but

instead use their financial clout to push a social and political agenda shrouded in secrecy” .

The project *'Green Finance and Climate Policies in Canada and Germany'* stepped into this controversy by asking:

- How green are Green Bonds?
- Is ESG making a meaningful contribution to climate policies?
- What type of regulatory regime is required to make Green Bonds and ESG investments to drivers of reallocation processes towards zero carbon emission activities?

## **State of the Play**

Green finance is an umbrella term that covers various financial instruments. Depending on the definition of 'green', data on the size of markets for green financial instruments vary. For example, the Climate Bond Initiative (CBI) estimated for 2020 total issuances of ten bonds at over \$1 trillion. According to a report by *The CityUK*, the global green bond market has grown from \$ 5.2 bn in 2012 to \$511.5 bn in 2021 - to half of CBI's estimated size. Both studies stress



that green bonds are on a growth trajectory. What sounds like good news needs to be related to the overall size of global bond markets of \$100 trillion. In

other words, only a tiny share of bonds issued by various parties come with green traits. The picture looks rosier for ESG investments. According to Bloomberg, ESG assets were more than \$35 trillion in 2020 compared to \$22.8 trillion in 2016. The share of ESG investments in total global assets would then be about 33%). It seems, however, that the underlying measurement of ESG investments is relatively comprehensive and may exaggerate the reality on the ground.

*"Financial markets can help solve the climate challenge by meeting the growing demand for low- carbon projects around the world, from urban transit infrastructure to renewable energy facilities. New financial tools like green bonds are helping drive more capital to these projects, and as this report shows, clear standards and better market data will accelerate the use of green bonds by making them an even more attractive way to invest."*

*Michael R. Bloomberg, United Nations Secretary-General's Special Envoy for Cities and Climate Change*

The opaqueness of data is not solely a statistical problem. Without a clear definition of 'green' and 'ESG investment,' investors run into the problem of moving funds into financial vehicles that do not support a path change. At the same time, opaque concepts of green financial products open the door for deliberate greenwashing strategies.

## **Standards and Norms as Key Elements of a Green Financial Regime**

As a follow-up of the Paris Agreement of 2015, the European commission started developing an Action Plan on Financing Sustainable Growth. In EU parlance, the financial system, nationally and internationally, has to move towards



sustainable finance - whose role is to 're-orient investments towards more sustainable technologies and businesses, to finance growth in a sustainable manner over the long-term, and to contribute to the

creation of a low-carbon, climate-resilient and circular economy'.

Already early in 2018, a High-Level Expert Group on Sustainable Finance, commissioned by the EU Commission, published its final report, which included far-reaching recommendations on integrating sustainable finance within the EU and broader global financial systems: creating a sustainability taxonomy; introducing a reporting requirement of 'green' investors and asking for disclosure on financial risk structures of investors; developing EU-wide sustainability standards and labels, in particular for green bonds; integrating sustainability into the governance of financial institutions as well as in financial supervision <sup>1</sup> This study added proposals to an already sizeable global *market of standards* and norms fueled by the public, supranational and private efforts to establish codes and definitions for green financial products. According to the *Green Finance Platform* of the World Bank, *governments and regulators issued over 780n+ green finance measures*<sup>2</sup> Additionally, private actors and supranational institutions came up with their criteria. Examples are International Finance Corporation (IFC) Performance Standards, Inter-American Development Bank (IADB) Environmental and Safeguards Compliance Policy, Barclays Impact. Eligibility Framework for Shared Growth Ambition or HSBC's Sustainability RiskPolicy); UN Principles

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<sup>1</sup> <http://sdg.iisd.org/news/eu-expert-group-provides-recommendations-for-sustainable-finance/>

<sup>2</sup> <https://www.greenfinanceplatform.org/financial-measures/browse>.

of Responsible Investment (PRI)), CICERO, Climate Bonds Initiative (CBI)), Global Reporting Initiative (GRI), the Sustainable Accounting and Standards Board (SASB), the Taskforce for Climate-Related Financial Disclosure (TCFD), International Capital Market Association (ICMA), Global Impact Investing Network (GIIN)), and NGOs (e.g., Impact Management Project—IMP, Carbon Disclosure Project—CDP investors. Green bonds regulation is mainly in the form of self-regulation. For instance, the Green Bond Principles (GBP) – developed by the International Capital Market Association – and the Climate Bonds Standards by the Climate Bonds Initiative are two widely adopted market regulations for investigating the greenness of the underlying activities with green bonds and then certifying them. These market standards, however, are still quite vague due to the lack of clear definitions of green financing projects and universal taxonomies.

Only some of those initiatives may survive long-term, as investors and regulators are looking for standardized norms. A universal and coherent regulatory regime is a widely acknowledged systemic problem, yet challenging to overcome, not least due to divergent interests and regulatory practices.

Key global rule setters may eventually converge towards creating a *gold standard*. At the very top stands the

*Taxonomy* of the EU, not least because the EU is widely seen as a global regulatory power and may extend this power to the financial arena.

The Taxonomy, so the EU Commission, is a classification system that establishes a list of environmentally sustainable economic activities so that companies, investors and policymakers are provided with clear definitions for which economic activities can be considered environmentally sustainable.

The intention is to 'create security for investors, protect private investors from greenwashing, help companies to become more climate-friendly, mitigate market fragmentation and help shift investments where they are most



needed.' Coming into force in 2020, the EU taxonomy is currently available for two goals: climate change mitigation (with four additional environmental objectives) and social sustainability. The taxonomy defines some substantial climate-neutral and environmentally sustainable activities and lists transitional and other enabling activities that help companies become more sustainable. From 2022, non-

financial companies must report the share of taxonomy-aligned revenues and investments at the entity level, and the same will be applied to financial institutions from 2024. An advisory body (Platform for Sustainable Finance) has been created to finetune and modify the various parts of the Taxonomy.

## **The Case for a Coherent Green Finance Regime**

There is no good reason to expect that private companies would automatically go for green investment strategies or that investors would prefer financial instruments like Green Bonds over common bonds. It is now more than twenty years ago that Milton Friedman gave a clear-cut statement on the role of business in society: ‘There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits.’ If one follows this dictum, green investments will only be made if those investments show a superior rate of return. The question of a *greenium* has been widely researched. In a remarkably nuanced analysis, Caroline Flammer showed that green corporate bonds come with a *greenium*. However, such a premium rate of return is only



delivered by certified green bonds, i.e. bonds regulated and monitored within an adequate regulatory regime. Non-certified bonds, in contrast, are without a premium rate of return. A study by the ECB, to name another example, comes to similar results.

Such findings make a strong argument for a *coherent and universal regulatory regime* to avoid greenwashing strategies and help channel financial resources into climate-friendly activities. This is particularly critical for the sub-type of *corporate* green bonds.

The EU's Green Bonds standard attempts to guarantee investors that all the bond proceeds will be used to finance taxonomy-aligned activities. This standard has the potential to increase the number of Green Bonds significantly. The Commission tries to bring more transparency to existing certification schemes for Green Bonds. The *EU Ecolabel* is another regulatory tool based on the taxonomy that awards top environmentally performing financial, deposit, and insurance products. Moreover, the EU has been expanding the regulatory network for sustainable finance by establishing the *EU Sustainable Finance Disclosure Regulation*, *Corporate Sustainability Reporting Directive*, and *Corporate Sustainability Due Diligence* directly regarding supply chains.

### Corporate Green Bonds

- *Corporate green bonds have become increasingly popular in recent years. They are more prevalent in industries where the natural environment is financially material to the companies' operations (e.g., energy) and are especially prevalent in China, the U.S., and Europe.*
- *Certified-Green bond issuers improve their environmental performance post-issuance: certified green bonds are associated with an increase in the company's environmental rating and a decrease in CO2 emission.*
- *The green bond market currently relies on private governance regimes. Existing certification standards by independent third parties (e.g., the climate bonds standards of the Climate Bonds Initiative) lack a coherent definition of 'green' projects, universal rules and standardization in green finance taxonomies, and enforcement mechanisms as public regulations.*

And yet, most Green Bonds are not issued by the private corporate sector. In Germany and Canada, all issued public Green Bonds had been oversubscribed, indicating strong demand for such a bond issuance relative to supply. In both countries, pension funds and large insurance companies – together with some other institutional investors – are investing heavily in these green bonds. The federal government, the KfW (Kreditanstalt für Wiederaufbau), and the Landesbanken are these bonds' leading issuers and investors. In contrast, German private banks seem far more concerned about their lending business than corporate

issuance of green bonds. Rather, they engage more in incorporating environmental, social, and governance (ESG) factors and information on green projects into their internal processes of lending and pricing decisions. This pattern can also be observed in Canada and across Europe.

A prominent reason for the relatively slow development of corporate green bonds is the dearth of good green assets that can be used to back these individual bonds. Compared to public institutions, corporations in Canada, for example, don't have many green assets that they can use to securitize and then issue to the market. Still, in the Canadian market, the issuance of broader defined sustainability bonds has become popular over the last 2-3 years. These bonds, issued mainly through energy-producing companies, are not backed by green assets.

A coherent and universal regulatory regime may also be effective in preventing investments from offshoring to countries with less stringent taxonomy and standards. Increasing the taxonomy alignment of actors within the EU will increase the incentive for investors to look greener, which will be a disincentive toward investing in activities not aligned with EU's sustainability criteria.

Rather than becoming the regulatory gold standard, the EU framework and initiatives in the U.S. and China may result in a global harmonization process harmonization of standards

among the world's three most significant markets. A harmonization of these standards, consequently, will help to reduce offshoring investments to countries with less stringent taxonomy and standards. Such a harmonization needs regulatory cooperation between those jurisdictions.

## **Challenges**

A strict regulatory regime potentially encourages increasing the issuance of private and public Green Bonds. The development of a universal regime would also significantly impact enterprises' operation and management, especially multinationals with long global *supply chains*. Such laws and regulations would require companies to establish or update compliance management systems with much more transparency and reporting duties. Firms would also be required to establish risk frameworks concerning protecting the environment alongside their supply chain. Furthermore, regulatory instruments as proposed by the EU would not only address companies incorporated in any EU member. American or Canadian companies operating in the region would also fall under the scope of these rules and comply with EU standards.

Greening supply chains is more than a logistical challenge. It may also pose trade policy issues as non-EU jurisdictions may see the taxonomy as an intervention into their political realm.

There are also challenges in operationalizing the EU taxonomy that need to be addressed., most prominently the need for more solid *data*. For example, to fully comply with the taxonomy-aligned disclosure requirements, many financial institutions in Germany have reported a need for systematic and reliable data from their clients and investees. Additionally, the complexities of the taxonomy create challenges for financial institutions – especially those with small sizes and limited resources – to interpret the criteria.

*Opaqueness* is an even greater problem for ESG. Billio/Costola/Hristova/ Latino/Pelizzon (2020) show in a comprehensive analysis 'that heterogeneity in rating criteria can lead agencies to have opposite opinions on the same evaluated companies and that agreement across those providers is substantially low. Those alternative definitions of ESG also affect sustainable investments leading to the identification of different investment universes and consequently to the creation of different benchmarks. This implies that in the asset management industry it is extremely difficult to measure the ability of a fund manager if financial performances are strongly conditioned by the chosen ESG benchmark. Finally, we find that the disagreement in the scores provided by the rating agencies disperses the effect of preferences of ESG investors on asset prices, to the point that

even when there is agreement, it has no impact on financial performances.”

Such a disillusioning finding devalues otherwise good news that, for example, nearly all companies (roughly 97 to 98 percent) listed on the Toronto Stock Exchange are actually disclosing their ESG performance. This high number comes with a considerable variation within the energy sector in ESG disclosure. Only about a third of wind and solar companies (around 33%) put out their ESG or sustainability disclosure, compared to 40% of pipeline operators and 75% of electric utility companies. Company size and ownership are important factors influencing ESG disclosure. Top energy producers with more resources gathering and analyzing relevant ESG information are more willing to disclose their ESG performance than small companies. Small companies with limited resources, on the contrary, are much more on the fence as they are still determining whether it is better to spend the resources disclosing/reporting their practices or actually doing better to improve their sustainability performance. Public companies concerned about attracting green investments – and those owned by municipalities – are more likely to opt for ESG disclosure than private ones.

## Policy Implications

- Green financial products are critical to the transition to net zero carbon emission economies. Even though green financial products have become more prominent, they still make up only a tiny fraction of all financial products. The move from brown to green economic activities requires a selective discrimination of non-green financial products.
- Certification regimes for green financial products need to be made universal to avoid the misallocation of resources and the practice of greenwashing. The taxonomy provided by the EU can be the base for creating and designing a universal regime. Governments and supranational institutions must launch a global forum for an agreement that results in a universal regime.
- Rather than adding more detail to the concept of ESG, it is suggested to reduce ESG to 'E' and to decouple 'S' and 'G' to separate reviews. In this way, large and particularly small and medium-sized companies are not burdened with high information and reporting costs.

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*Links to the Webinars*

Webinar 1: <https://www.youtube.com/watch?v=aixPYGTzowM>

Webinar 2: [https://www.youtube.com/watch?v=yn\\_j3DXkTPw](https://www.youtube.com/watch?v=yn_j3DXkTPw)