PRESS RELEASE

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The development of robust and transparent carbon markets could help decarbonise the global economy

New report from GIC, the Singapore Economic Development Board, and McKinsey highlights the potential of carbon markets as a viable asset class for advancing climate goals

29 October 2021 – GIC, the Singapore Economic Development Board (EDB), and McKinsey & Company on Friday (Oct 29) published a joint report, *Putting carbon markets to work on the path to net zero: How investors can help decarbonise the economy and manage risk-adjusted returns.* The research outlines how institutional investors can play a critical role in helping to develop viable carbon markets in their pursuit of global climate goals, whilst also fulfilling their own mandates.

According to the analysis, carbon markets are rapidly approaching critical mass from an institutional investment perspective.

Compliance carbon markets (CCMs)* have matured over time, with a global market value of over US$100 billion, and are becoming easier for investors to understand. Voluntary carbon markets (VCMs), on the other hand, are much smaller at US$300 million in value, making them largely unviable for institutional investment today.

With more standardised and transparent pricing, and more established governance mechanisms, however, VCMs could outpace CCMs to bring them to a similar total global market value as soon as 2030.

“Well-governed, liquid and scalable carbon markets could play a significant role in meeting global climate goals. Carbon markets must, however, not divert efforts from cutting carbon emissions at source, and should contribute to the overarching goal of a low carbon future. Our paper found that with greater scale and more robust governance standards, carbon markets could offer investors an effective tool to manage climate-related risks, and to support portfolio companies in their transition journeys”, said Liew Tzu Mi, Chief Investment Officer for Fixed Income, and Chair of the Sustainability Committee at GIC.

One in five of the world’s 2,000 largest publicly listed companies have now committed to a net zero emissions target, along with countries responsible for 61 percent of global GHG emissions. To achieve these targets, companies must work towards decarbonising their own operations and value chains, while compensating for and neutralising their existing and residual emissions through high-quality carbon credits.

Institutional investors also have an interest in driving decarbonisation efforts, since their portfolios are being exposed to increasing levels of climate risks.

Working with Vivid Economics, McKinsey's strategic economics consultancy, and its climate analytics suite, Planetrics, the researchers conducted bottom-up modelling of the relative impact of climate risks across individual asset classes. They found that, in scenarios assuming immediate or even delayed climate action, carbon allowances could improve the risk-adjusted returns of a 60/40 reference portfolio†. On average, an allocation of approximately 0.5 to 1 percent was sufficient for portfolio risk diversification under climate transition scenarios. The only scenario in which carbon allowances led to decreased returns was one where no new climate change policies were introduced.

While the reasons for institutional investors to consider active participation in carbon markets are compelling, they also need to be mindful of their role in providing useful services such as liquidity, price discovery and matching supply and demand, and to refrain from speculative trading.

"Decarbonisation is no longer in just one company's, one industry's, or one nation's interest. Everyone has a role to play. Our research suggests that institutional investors can help to create healthy and viable carbon markets in support of a low carbon world," said Badrinath Ramanathan, a Senior Partner and Managing Partner of McKinsey & Company in Singapore. "Importantly, their participation must be coupled with an understanding of the reputational and financial risks inherent in carbon markets. In all cases, investors will have to make decisions with environmental integrity in mind – ensuring their actions are always aligned with the ultimate goal of decarbonisation."

The authors believe that institutional investors can help accelerate the development of VCMs in three key ways:

- by supporting the establishment of high-integrity standards and governance for carbon credits;
- by investing directly and helping to scale up the supply of high-quality compensation and neutralisation projects; and
- by guiding portfolio companies on their journey to becoming more sustainable.

"Well-functioning carbon markets can play a complementary and important role to meet climate goals. Investors can play a part to support the growth of such markets, such as by closing the climate finance gap in high quality compensation and neutralisation projects such as Natural Climate Solutions (NCS). The paper discusses the different ways investors can play a role and the risks they should watch out for," said Adeline Aw, Vice President, Environmental Sustainability, Singapore Economic Development Board. "The climate crisis requires collective action. Singapore, at the heart of Asia and as a growing carbon services and green finance hub, can play a part to promote and catalyse the growth of trusted and high-quality carbon markets."

Ultimately, investors should keep in mind that carbon markets are one of several solutions that could help accelerate the low carbon transition. Equity and bond markets serve broader social objectives such as economic growth, prosperity and value creation, and can generate returns for investors as a by-product. Likewise, the ultimate objective of VCMs and CCMs is to help the world set a path to net zero emissions in line with the Paris Agreement.

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Editor’s note

*Compliance carbon markets (CCMs) are traded and regulated by mandatory national, regional or international regimes, while voluntary carbon markets (VCMs) are traded by companies and individuals on a voluntary basis to achieve carbon compensation and neutralisation.

† A 60/40 reference portfolio refers to 60 percent equities and 40 percent bonds, where iShares MSCI ACWI ETF is used as the proxy for the equity part of the portfolio and J.P. Morgan Global Government Bonds Index for the bond part of the portfolio.

About GIC

GIC is a leading global investment firm established in 1981 to secure Singapore’s financial future. As the manager of Singapore’s foreign reserves, we take a long-term, disciplined approach to investing, and are uniquely positioned across a wide range of asset classes and active strategies globally. These include equities, fixed income, real estate, private equity, venture capital, and infrastructure. Our long-term approach, multi-asset capabilities, and global connectivity enable us to be an investor of choice. We seek to add meaningful value to our investments. Headquartered in Singapore, we have a global talent force of over 1,800 people in ten key financial cities and have investments in more than 40 countries.

For more information on GIC, please visit gic.com.sg, or follow us on LinkedIn.

About the Singapore Economic Development Board

The Singapore Economic Development Board (EDB), a government agency under the Ministry of Trade and Industry, is responsible for strategies that improve Singapore’s position as a global centre for business, innovation, and talent. We undertake investment promotion and industry development, and work with international businesses, both foreign and local, by providing information, connection to partners and access to governmental incentives for their investments. Our mission is to create sustainable economic growth, with vibrant business and good job opportunities for Singapore and Singaporeans.

For more information on EDB, please visit edb.gov.sg.

About McKinsey & Company

McKinsey is a global management consulting firm committed to helping organisations create Change that Matters. Located in more than 130 cities and 65 countries, our teams help clients across the private, public and social sectors shape bold strategies and transform the way they work, embed technology where it creates value, and build capabilities to sustain the change. Not just any change, but change that matters – for their organisations, their people, and for society at large.

For more information on McKinsey, please visit mckinsey.com.

About Vivid Economics

Vivid Economics is a strategic economics consultancy spanning public policy and support for commercial decision making with a broad, international focus and a deep specialisation in carbon markets. Our climate analytics suite – Planetrics – helps quantify, report and manage climate risks and helps our clients navigate the urgent implications of climate change and move towards net zero carbon emissions. As of 4 March 2021 Vivid Economics and Planetrics are now part of McKinsey.

For more information on Vivid Economics, please visit vivideconomics.com.