It's time for accountancy to put climate change at the ...

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Mark Carney, the governor of the Bank of England, has an article (with coauthors) in the Guardian this morning on the threat that climate change poses to business and banking. I applaud him for this: he has had the courage to act when others have not. That needs to be said.

I have little doubt that some who yesterday called me an idiot and worse in the comments section of this blog for questioning the investment appraisal technique known as 'discounting' will apply similar language to Carney. I think this point worth elaborating for three reasons.

The first is that it is fundamental to avoid a financial meltdown as we also tackle global warming: dealing with the latter will be hard enough without it triggering the former.

The second is that unless there is massive re-education on this issue we will continue to face that risk of financial meltdown, and accountancy, in particular, is spectacularly ill-prepared for this.

And third, I happen to be talking about it tonight in a workshop at the Young Vic, and so I am writing this as preparation for that event.

Dealing with the core issue, it is simply stated. As Carney has appreciated global warming poses at least two quite fundamental risks to finance. There are more, but these two will do.

One is to banking. Given that the vast majority of banking involves loans made with security the quality of the security available to guarantee repayment of loans is fundamental to the success of its business model. The trouble is that most of that security is in the form of mortgages on land. And most of the land that is used for security is in major conurbations. And most of the world's major conurbations face a threat from rising water levels, and so flooding. The result is that the value of that land is likely to fall dramatically over coming years unless serious action to tackle global warming and (I stress the 'and', because I think it necessary) action to prevent that flooding is taken. The situation is, of course, no better for farmland and industrial complexes: most of that faces the same risk. So the whole collateral model on which modern banking is based is likely to fail, and with it the loan portfolio of all banks. This is a business model on the brink as a result, quite literally. But most have not accepted that fact as yet.

And then there is the second threat, which is to much of our ‘heavy’ industry, This is massively carbon dependent. Very large parts of pension portfolios are still dependent on investment in the shares of such companies. And as Carney appreciates, but it appears that too many investment managers do not, the valuations of these companies are based on the possibility that they can exploit, in perpetuity, the carbon-based assets they claim to own. So they assume all the oil they claim to have found can be extracted, and so on. Except it can’t be; at least, not if we are to survive on earth. That is not possible. And the range of investments impacted is quite phenomenal. Whole market sectors might well be seriously overvalued as a result.

Carney has appreciated this core problem that climate warming fundamentally threatens the business models of much of our economy. And he has realised that this means that a great deal of the asset value which we supposedly enjoy at present is based on myths that are not true. Fundamentally, the myth that underpins financial markets is that we can burn the planet without consequence. And we know that is no longer the case.

So Carney is right to issue the warning. But there’s another line I want to pick up. What he has said is:

The success of these recommendations relies on two important factors, which lead to two broader calls to action on disclosure and classification of climate-related financial risks. First, to support the market and regulators in adequately assessing the risks and opportunities from climate change, robust and internationally consistent disclosure is vital. The market and policymakers must continue to work together to determine the most decision-useful metrics for climate-related financial disclosures.

Second, the NGFS encourages regulators to develop an adequate classification system to identify which economic activities contribute to the transition to a green and low-carbon economy. This will be particularly valuable in supporting financial actors to make sustainable investment and lending decisions.

He is right. And let me be emphatic that those systems will have to be based on models other than discounting, which I discussed (albeit briefly) yesterday. Discounting assumes that the values of cash flows in the future are worth less than they are today because of the impact of interest e.g. a pound in a years time with a 4% interest rate applying is worth near enough £96, and so on. Very rapidly, and depending on the interest rate chosen, a pound in the future is worth very little at all, with the result that action to prevent long term climate change does, using this investment appraisal method, deliver very little value at all. This is the fallacy that those in the capital markets who subscribe to this method of appraisal have succumbed to. And they are wrong to do so, and their advocacy of this technique is as a result quite literally dangerous to the prospect of even medium-term life on earth.

Carney knows this. His warnings on finance and its techniques, are apt. As are his warnings on financial reporting systems, but I would then ask you to note this comment from Hans Hoogervorst, the Chair of the International Accounting Standards Board (IASB). Speaking at the Climate-Related Financial Reporting Conference in Cambridge on 2 April, Hoogervorst started by admitting he had been both a right-wing politician and climate sceptic. He admitted to changing his mind on one of those issues, despite which he said:

[L]et me make clear that I do not think the IASB is equipped to enter the field of sustainability reporting directly. Setting sustainability reporting standards requires expertise that we simply do not have. Moreover, there are already more than enough standard-setters active in this field.

So what we have is the Governor of the Bank of England saying that we need fundamental reform to reporting and we have the International Financial Reporting Standard saying 'don't look to us to do that'. That is a conflict that has to be resolved, and quickly. And it goes to the core of accounting.

Either the IFRS Foundation does act in the public interest, and so has to embrace green reporting, in which case it must do so soon, or it does not embrace green reporting and so does not act in the public interest, in which case it must be swept aside soon and be replaced by a regulator for accounting standards who will take on that issue. There really is no ground between those two positions.

We re facing extinction. The wise know it, and will adapt their ways to it. And those who will not do so and who hold positions of authority need to be swept aside. The IFRS faces its own extinction event as a result. I am indifferent as to the outcome. But what I am not willing to tolerate, without comment, is it standing in the way of progress on managing the process of climate transformation, and that is what it is doing. It has to decide to act, or go: there are no other options.