

Are Financial Institutions the “Silver Bullet” for Environmental Markets?

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1. What Are They?
2. How Can They Help?
3. What Are Their Limitations?



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What Do Financial Institutions Do?

1. Lend
2. Invest
3. Underwrite
4. Trade
5. Advise
6. Insure

Who Does What?

	Lend	Invest	Underwrite	Trade	Advise	Insure
Commercial Banks	✓			✓		
Investment Banks		✓	✓	✓	✓	
Insurance Companies						✓

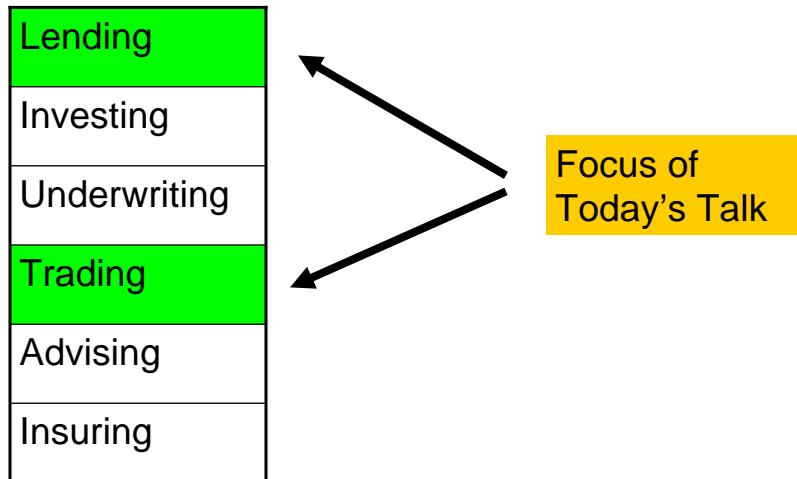
Some Real-Life Examples

Commercial Banking	Bradesco HSBC	JP Morgan Chase Bank of America	Citigroup
Investment Banking	Merrill Lynch Goldman Sachs		
Insurance	AIG		



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What is Most Relevant for Environmental-Services Markets?



Lending



Why Borrow?

- To obtain **cash** that is **needed today** but is not otherwise available
- Ex: A watershed authority wants to buy land today but will be receiving payments only in the future

How do Financial Institutions Decide Whether to Lend?

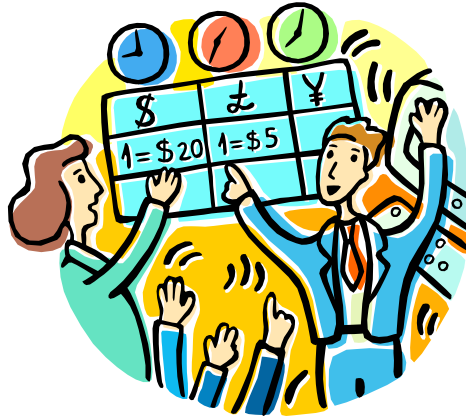
- Assurance of payback
- Can come from 3 sources:
 1. Hypothecation of an asset
 - e.g. cash, land
 2. Guarantee of a creditworthy party
 - e.g. government, rich uncle
 3. Future cash flows

No Assets or Rich Uncles? Then you need **cash flows!**

So what qualifies?

1. Without “Credit Support”
 - Based on historical track record
2. With “Credit Support”
 - Based on contract and/or law
 - Examples:
 - Big company agrees to make payments in future
 - Government will collect taxes

Trading



What is Traded?

Securities, Contracts, Other Assets

- A share in a company (stock)
- An obligation of a company (loan/bond)
- A ton of coffee
- Rights:
 - Right to buy stock in future
 - Right to pollute
 - Right to kill an animal
- Environmental offsets
 - Wetland mitigation

Why Is Trading Good?

- Establishes a price
- Lowers the price
- Reduces transaction costs
- Increases speed
- Attracts investors by providing entry and exit

GREED IS GOOD!



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What Do Financial Institutions Want in a Trading Market?



1. Property rights (ownership)

- Rule of law
- Enforceability of contracts



2. Liquidity

- Lots of money, lots of players

3. "Trading Utilities"

- Exchanges, depositories, etc.

Who are the Buyers and Sellers?



1. "Natural" buyers & sellers

- Ex: Exxon buys, Petrobrás sells
- Without these, there is no market



2. Speculators

3. "Dealers"




- Take price risk
- Ex: wetland banks

Banks
do this

4. "Brokers"

- Matchmakers: no price risk

So Which Trading Markets are of Interest to Financial Institutions?

		
Kyoto CO2	Utah Prairie Dogs	Wetlands Mitigation
U.S. SO2		



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Are Financial Institutions
the Silver Bullet?



Not Necessarily!

- **They don't set up the markets**
 - ALL MARKETS first need natural buyers and sellers
 - ENVIRONMENTAL MARKETS often also need government action
- **Many PES systems involve only direct payments**
 - E.g. government or company pays forest owners directly
- **Many markets are unattractive to the big banks**
 - Small
 - Insufficient legal support
- **Borrowing is not always needed**
 - E.g. some tax-based systems, much of cap & trade

So What Can We Expect?

- Financial institutions can be helpful, but not in all cases
- The largest trading markets will attract the big players
- Smaller trading markets—e.g. offset trading—can attract specialized players
- Lending is a possibility
- **BUT FIRST** markets must be designed and established!

The Dog Wags the Tail!

