



Subprime Carbon – Offsets & Lessons from the Credit Crisis

To effectively address climate change, the United States needs robust domestic emissions reduction targets and policies that send the correct signals to change industry behavior and produce real emissions reductions. The implementation of a cap and trade program is viewed by many as a way to use the market to achieve these reductions. However, over-reliance on a cap-and-trade program to solve climate change raises a number of concerns, particularly in terms of the monitoring, evaluation, and verification of carbon credits in a global market. *Unfortunately, the federal cap and trade proposals put forth so far would create a system that poses almost identical challenges as those in the mortgage-lending industry.*

Our nation is currently facing an historic financial crisis that can provide us with a cautionary tale about a cap and trade program. The subprime mortgage meltdown occurred when banks bundled together high-risk and lower-risk mortgages into packages that were then bought, re-bundled and re-sold many times over, creating promised revenues that were increasingly difficult to track. When it became clear that a significant portion of the loans were bad, the whole system began to unravel. This affected everyone in the banking and investment system connected to these bundled mortgages, including average Americans with savings accounts and retirement savings, and turned a sub-prime mortgage problem into a system-wide credit crisis.

Will questionable emissions credits lead to an overabundance of “subprime carbon”?

The subprime mortgage crisis was generated by questionable loans and a failure of market checks and balances. A cap-and-trade program could face similar questions in terms of emissions reductions associated with carbon offset credits, which are likely to be tradable on open carbon markets. For offset projects to work, they need to result in real decreases in the amount of carbon pollution emitted. But not all offset projects clearly lead to emission reductions.

Some of the most visible carbon offset scandals to date include:

- the construction of large, environmentally destructive dams, where builders who were going to construct the dams anyway claimed “new” emissions reductions;
- HFC (a chemical byproduct of refrigerant production) destruction projects, where factories purposely created these very potent greenhouse gas chemicals just so they could destroy them and make money off of the credits; and
- forest-related carbon reduction schemes where trees have been planted to store carbon, only to die a few years later;

As carbon traders develop derivatives products, which are based on promises to deliver carbon credits at a future date for a specified price, a real risk of “subprime carbon” (carbon assets that fail to deliver, called “junk carbon” by traders) emerges. Given the potentially huge size of the carbon trading market, and the increasing complexity of carbon derivatives, the risk of subprime carbon contagion is a real possibility, particularly if the current credit crisis fails to spur fundamental regulation of the financial market.

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Will carbon markets be plagued by unscrupulous intermediaries?

The subprime crisis was exacerbated by the proliferation of mortgage brokers and other middlemen who provided questionable, if not unscrupulous, services. In the past decade, the seemingly limitless appetite for mortgage lending and mortgage-backed securities fueled a dangerous deterioration in lending standards. Since carbon is predicted to “be the world's biggest commodity market, and it could be the world's biggest market overall,”¹ a speculative carbon bubble could similarly spur the development of subprime carbon assets.

Like mortgage brokers approving “ninja loans” (loans to borrowers with no income, job, or assets), unscrupulous intermediaries may overpromise on offset projects by selling future credits based on projects that do not exist and may never come into being, are not additional, or which simply do not deliver the promised greenhouse gas reductions. If Wall Street financiers continue employing the “originate and distribute” strategy (in which banks offload their risks to investors in the secondary markets), banks and intermediaries will still pursue lucrative fee-based business with little regard to the risks they are passing on to investors.

Will asset valuation be properly determined?

“Innovative” financial engineering characterized the credit crisis, where the complex financial instruments created to enable loans made it very difficult to determine the actual value of assets. Credit rating agencies, which were supposed to provide rigorous assessments of mortgage-backed securities, could not analyze thousands of individual mortgages, and thus relied on financial models, which were ultimately flawed.

As secondary carbon markets grow, spawning the creation of new derivatives and structured products, rating agencies and analysts will face similar asset valuation challenges. Analyzing the quality of underlying carbon offset projects will be as difficult, if not more so, than analyzing mortgages, and may be even less suited to modeling.

Will players in the carbon finance markets succumb to conflicts of interest?

After the Enron accounting scandal of 2001, some new regulations were issued to reduce conflicts of interest. For example, today accounting firms have separated their auditing and consulting functions, and in June 2008 the Securities and Exchange Commission issued new rules to reduce conflicts of interest among credit ratings agencies. However, conflicts of interest still exist, both in the broader financial sector and in the carbon finance market.

For example, similar to how credit rating agencies helped design complex structured finance products and then also rated them, consulting firms offering advice on developing carbon offset projects may also earn fees for verifying emissions reductions from projects. Banks which own equity stakes in carbon offset projects may also be carbon brokers or sector analysts, creating a temptation to bid up carbon prices to increase the value of their own carbon assets. Such conflicts of interest compromise the integrity of the carbon markets, from both a financial and environmental perspective.

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¹ Kanter, James, " Carbon trading: Where greed is green," *International Herald Tribune*, 20 June 2007.