Association for Financial Markets in Europe

The Low-Carbon Transition – Why are compliance and voluntary carbon markets so important?

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When policymakers congregate at COP26, there will be a sense of urgency. The world is falling short in its battle against climate change. To limit temperatures from rising above 1.5 degrees in the next two decades transformational changes are needed in the global economy. One key lever in this transformation will be to achieve a rapid scaling and deepening of carbon markets.

What are compliance and voluntary carbon markets?

Carbon markets are based on the purchasing of credits (allowances) that enable an entity to offset its carbon output. These markets are split into two categories: compliance and voluntary markets. Compliance markets aim to establish a carbon price by laws or regulations which control the supply of permits that are then distributed by national, regional and global regimes. These permits are then traded within a controlled emissions trading scheme (ETS), which economically incentivises emitting organisations to reduce their carbon footprint.

In contrast, voluntary markets are not legally mandated and consist of companies and individuals choosing to offset their emissions. This could be motivated by an organisation looking to offset longer-term climate risks facing their organisation or for ethical or other reasons. Due to the carbon credits in voluntary markets not being administered by a specific government, they are accessible to every sector globally in contrast to compliance markets.

Both compliance markets and the voluntary carbon market can play significant and complementary roles in the decarbonization of the global economy. However, both categories are undersized. A report produced by the Global Financial Markets Association (GFMA) and the Boston Consulting Group (BCG) finds that close to 80% of greenhouse gas emissions are not covered by regulated carbon pricing in compliance carbon markets. This limits their effectiveness in accelerating the global green transition.

Expanding ETS Scale

Within ETS coverage/compliance markets there is scope to expand not only within and across sectors but also the number of countries or municipalities. By including sectors that will need to acquire sizeable credits to offset their carbon output, the ETS will gain scale and more accurate pricing that will aid in the global green transition. To accelerate the expansion of the ETS scheme, policymakers should look to include more high-intensity emission sectors. These include energy and power as well as transportation, oil and gas industries (to name a few).

Furthermore, the integrity of the ETS scheme needs to be facilitated. Collecting verified emissions data and classifying carbon allowances as financial instruments, as already done in the EU, would help ensure financial and price stability.

The Integrity of Voluntary markets

Similarly, voluntary carbon markets have the potential to channel finance into carbon removal projects and address the residual emissions of firms, but they are held back by issues of market integrity. This includes a lack of consensus on how the market credits align with science-based decarbonisation pathways, the overall "quality" of the credits available, as well as fragmented reporting standards.

For voluntary markets to fulfil their potential, standard-setting bodies need to develop a consensus on the role of voluntary carbon market credits. This includes providing guidance on the accounting and disclosure for the credits and how they relate to net-zero/carbon-neutral claims. Providing this guidance will help remove ambiguity from the market and avoid greenwashing.

Regarding the "quality" of credits, standard-setting bodies should also apply consistent standards for the underlying projects. By providing transparency and clarity surrounding the quality of credits, participants can gravitate to the credits that suit their needs.

Lastly, market participants should also create global registries that reduce the fragmentation of the voluntary credit market across regions. A unified registry will enable more seamless transactions and enable authorities to track global progress toward the Paris Agreement goals. This would also allow them to identify the next necessary steps to accelerate the global transition.

When key stakeholders and policymakers gather at COP26, scaling carbon markets should be pursued with a sense of urgency. If the world is to prevent global temperatures from rising beyond 1.5 degrees in the next two decades, ambition in scale, interoperability and market integrity will need to be achieved in carbon markets. Like any flourishing financial market, carbon market credits need to be regulated, valued and trusted. Carbon markets are very much still in their infancy, but the world cannot afford them to remain this way for much longer.