Fraud and Corruption in the Carbon Finance Markets – Lessons learnt

Carbon Finance, while still a relatively new concept for most of us, is increasing in its significance for anti-corruption professionals. As new initiatives and systems are created to finance climate change mitigation and adaptation, the subsequent challenges of dealing with the risks of corruption, fraud and money laundering are becoming much more prominent. While the future of what these new structures will ultimately look like is unclear, questions are arising with regards to how to govern these new systems; "What are effective governance systems to manage the tens of billions in monetary flows pledged to implement Greenhouse Gas (GHG) mitigation and adaptation strategies in less industrialised nations? How are they best implemented and monitored? How can we ensure that they provide the biggest environmental (and social) impact per dollar spent?"

Developing countries have already started to receive financial support to build institutions and systems to promote transition to low-carbon development pathways and additional funding has been pledged. One such example is a partnership agreement signed between Norway and Indonesia. Norway has agreed to support efforts in Indonesia to reduce GHG emissions from deforestation and degradation of forests and peat lands. The total pledge value is up to US$1 billion which will be distributed in a three step process over the next 7-8 years.

The Norway-Indonesia (Reducing Emissions from Deforestation and Forest Degradation) (REDD+) Partnership is based around full and effective participation of all relevant stakeholders. Part of the agreement is that the funds will be managed by an internationally reputable (local) financial institution to ensure that the environmental impacts are real, measurable and of sufficient scale and quality to ensure value for money. While the search is still on for an institution to manage these funds, the interim responsibilty resides with UNDP. Yet, despite significant donor, multilateral and NGO activity, a lack of clarity remains around the actual monitoring of financial and environmental impacts, and the position of this financial management institution in the highly complex political domestic landscape, i.e. existing central and regional government institutions, donor and multilateral agencies, private companies and civil society.

Lessons Learnt

As the first commitment period under the Kyoto Protocol (2008-2012) comes to a close and with no continuing international mechanism agreed at this time (post 2012), we can look at lessons learnt from industrialised nations that have taken part in this first Kyoto period. What fraud and corruption-related challenges have they faced and what lessons can be learned from these experiences as we move forward? This article presents an example of the issues faced and lessons learned.

Case Example: Corruption in the Ukraine under the Kyoto Protocol

An investigation undertaken in 2010 in the Ukraine has shown us that funds received totalling €320 million for the sale of Assigned Amount Units (AAU's) to Japan and Spain under the Kyoto Protocol can be open to government corruption. While the funds received were maintained in segregated accounts, the former Prime Minister ordered and approved that the funds be transferred to other state activities to cover budget deficits contrary to international contracts signed, local legislation and the Kyoto Protocol that required that the funds received should have been allocated to "greening activities."

This example shows that despite best intentions, governance systems to prevent corruption can be bypassed, and funds received by a government for implementing mitigation or adaptation-related activities misappropriated. Earmarking of funds against specific activities and in segregated accounts may help to reduce this risk. Additionally, payments should be made against specific, existing investment opportunities agreed upfront among counterparties; and there must be adequate government capacity to properly manage and disburse them.

Case Example: European Emissions Trading System (EU ETS)

Many lessons have been learnt from the existing carbon market mechanisms, most specifically with the EU ETS which shows us the current models are not without their challenges. Fraudulent activity has plagued the EU ETS System in recent years with almost 4 million credits totalling more than €60 million being stolen from countries such as Austria, Greece, the Czech Republic, Poland and Estonia, mostly through computer phishing attacks. Additionally, Value-Added Tax (VAT) 'carousel' fraud, where a criminal invoices for VAT but disappears before the tax is paid to the authorities, has also been a problem. According to Europol, about €5 billion has been lost VAT Fraud in the ETS. This demonstrates the importance of proper financial accounting systems and legal frameworks within each country and that reforms to existing national systems may be required for receiving GHG mitigation or adaptation funding.

This example also highlights the importance of establishing and maintaining credible and comparable national registries, linked through a central international registry. The purpose of these registries is to track both the sources and uses of funds as well as the environmental impacts of the investments. The organization that manages the current system (UN Framework Convention on Climate Change, UNFCCC) currently allows countries to build their own registries, within a set framework. However, to date, comparability has been relatively low, and there are no financial indicators.

It will be a great challenge to ensure that the appropriate governance structures and insitutions are developed and implemented to provide effectiveness against corruption. This is particularly pertinent as structures are increasingly being established in developing countries. It is, however due to the lack of clarity about post-2012, still very much a moving picture, but evidence-based research and documentation of country experiences in creating national frameworks is continuing. Anti-corruption professionals will undoubtably have a role in helping to design appropriate systems to reduce risk, and to monitor the performance of these, in order to ensure a smoother transition to "green" economic growth.

Transparency International has released a comprehensive new report "Global Corruption Report: Climate Change" last weekend which can be downloaded from the website.

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