Briefing

Tackling economic challenges with green finance

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green alliance...

Summary

The UK economy is facing two major challenges. First, soaring living costs, driven by inflation of 13.3 per cent in October and over 20 per cent in 2023. Second, flatlining economic growth with potential recession in the final three months of 2022.

This pressure on public finances puts a premium on stimulating private investment to tackle inflation and revitalise the UK's economy. A greener future for the financial services sector post-Brexit will be central to achieving that.

As the UK Green Finance Roadmap sets out, aligning the financial system with net zero will "boost economic growth, create jobs, and level up the UK regions". Channelling investment into cheap, reliable and clean electricity can tackle gas-driven inflation, while emerging green markets offer investors higher expected returns.

This autumn, there are three opportunities to tap into the economic benefits of private green investment: the **Financial Services and Markets Bill**, the **Green Finance Strategy update** and the **Bank of England's climate and capital conference**.

The opportunity for green growth

The UK is the world's top net exporter of financial services. In 2020, the financial service sector contributed £164.8 billion to the UK economy, 8.6 per cent of GDP, employing 1.1 million people.

International and national net zero commitments show that the future of finance is green. The UK is already a leader in this, with London ranked as the top financial centre, ahead of Amsterdam, Stockholm and New York. This has been driven by private sector led innovation underpinned by strong government commitments and regulation.

While the UK is a leader on green finance, the country's financial sector still requires reshaping to build a productive, low carbon economy:

- **The financed emissions of the UK financial sector make it a larger polluter than Canada or Germany.** HSBC and Barclays alone provided $107.44 billion to 50 oil and gas projects in Europe between 2016 and 2021. This does little to bring down energy costs in the UK and is incompatible with net zero. Shifting investment towards clean and cheap homegrown renewable energy would reduce UK bills.

- **The London Stock Exchange is dominated by low growth mining, tobacco, and oil and gas companies.** Technology, meanwhile, makes up just two per cent of the market, well below the 20 per cent average across global markets. Supporting cutting edge green technology and fintech companies could help re-energise the City and boost its competitiveness.

Financial Services and Markets Bill

The Financial Services and Markets Bill represents the biggest shake up for the City of London since the 'Big Bang' in the mid-1980s. The bill will set the regulatory architecture of the UK financial services sector post-Brexit, repealing EU legislation, reducing regulation on firms, to try and stimulate UK competitiveness. Under such plans, UK regulators like the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) will be given greater supervisory and macro-prudential powers over firms and financial institutions.

The bill, as introduced, contains three major changes:

1. A secondary, statutory objective for the FCA and PRA to act in a way which promotes competitiveness and growth.
2. A regulatory principle for the FCA and PRA to contribute towards the UK's net zero target.
3. Changes to Solvency II, a risk-based capital regime, which would free up a portion of the loss-absorbing capital insurers are required to hold in reserve.

The Financial Service and Markets Bill has its second reading in the House of Commons on 7 September. The bill should be amended to:

- **Upgrade the regulatory principle to a statutory objective to drive faster action.** Regulators are not required to act on principles. A statutory objective would require regulators to ensure firms and financial institutions make progress against their net zero transition plans.
- **Target Solvency II reforms to drive forward clean and cheap electricity.** Reducing risk margins for insurers will release billions of capital held in reserve. It is critical this capital flows towards long-term green infrastructure projects, such as low carbon energy. The Net Zero Review found that GDP multipliers for investment in renewables is 2.2 to 2.5 times higher than fossil fuel energy investment.
- **Introduce a new parliamentary committee to scrutinise regulators.** The bill will give significant powers to UK regulators. A new parliamentary committee should be set up to probe appointments made by regulators and review the impact and effectiveness of regulation.

Green Finance Strategy update

Published in July 2019, the Green Finance Strategy is an overarching framework for how the UK will finance the net zero transition. The strategy set out three main objectives:

1. align the financial system with net zero
2. mobilise private finance towards climate and nature
3. capture the opportunities for the UK and its financial services sector.

In October 2021, the government pledged to update the strategy this autumn to reflect progress made so far and set out how the UK can better ensure the financial sector is supporting the UK's climate and environmental objectives. Government should:

- **Publish the update this autumn to work alongside the Financial Services and Markets Bill.** The government committed to publishing the update in late 2022. Setting out how the UK will finance the transition not only demonstrates global leadership ahead of the UN climate change conference in November (COP27) but provides market certainty for private lenders which is crucial for scaling up investment.
- **Deploy public policy and funding to leverage private finance.** Public funds should be used sparingly and in a targeted way to develop and derisk new green markets, for example through the UK Infrastructure Bank (UKIB). Areas in particular need of intervention include the natural capital market, ie clean water, natural flood management, and protecting and restoring biodiversity.
- **Empower regulators to hold businesses accountable.** Relying on investor behaviour and voluntary business practice alone will not shift the dial. Regulators should press financial institutions and firms to publish good quality disclosures and ensure meaningful progress is made against transition plans.

For more information on the Green Finance Strategy, see Green Alliance's briefing.

Bank of England climate and capital conference

On 19 October, the Bank of England will hold a conference on climate change and capital. The focus will be on adjusting the capital framework, ie the amount of liquidity banks must hold to mitigate climate related financial risks.

The Climate Biennial Exploratory Scenario (CBES), published on 24 May 2022, found that the UK's **financial system is exposed to high levels of climate related financial risk**, both from the direct impacts of climate change and the changes needed to achieve a net zero economy.

In the CBES report, the bank was clear that, whilst the tools at its disposal will help to ensure resilience against the consequences of climate change, "the responsibility for addressing the causes of climate change ultimately lies with governments, businesses and households". Therefore, parliament has an essential role in reducing the level of climate related risk the financial system is exposed to. One effective tool is:

- **Adjusting capital requirements to unlock barriers to investments.** Currently, the finance needed by the net zero transition exceeds the capability of the banking sector, due to post-global financial crash regulation. Capital requirements limit banks' abilities to provide long term project finance and should be adjusted so that financial institutions making lower risk investments, such as renewable energy, should be able to hold less capital in reserve.

Policy makers can provide the Bank of England with a strategic steer on adjusting capital requirements and can reflect climate related financial risk into government guarantee and loans schemes, setting a precedent.

For more information on the Bank of England and climate, see Green Alliance's briefing.

Green Alliance can provide support for parliamentary questions, media opportunities, briefings and meetings on greening the financial sector or anything else related to the information in this briefing.

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