Green Finance Strategy 2.0

The UK is a world-leader in green finance. Of the major global financial centres, London is ranked first for green finance according to the latest rankings from Z/Yen, far ahead of its major competitors including New York (ranked 13), Hong Kong (ranked 41), Singapore (ranked 16), Shanghai (ranked 14), Tokyo (ranked 22), Paris (ranked 10) and Frankfurt (ranked 44). Amsterdam comes a close second in the green finance rankings but is ranked 17 for overall global financial centre competitiveness and doesn't have anything like the scale of a London, New York or Hong Kong.

Green finance is a huge opportunity. We have entered the most capital-intensive period of human history. The transition to global environmental sustainability requires vast capital-intensive investments in every sector of the global economy. An estimated $125 trillion of investment is required just to tackle climate change, of which $37 trillion is needed this decade. Climate-related risks, including from the ever-increasing frequency and severity of extreme weather events requires insurance and re-insurance, as well as advanced data analytics and sustained investments in climate adaptation. Transforming companies and their business models requires capital and new financial products, as well as legal and other professional services. Green finance is a shorthand for these overlapping developments.

Current UK leadership didn't happen by accident. It is the result of a combination of factors, including the deep pools of expertise in climate and environmental science across the UK, policy innovation ranging from carbon markets and the Climate Change Act to the contracts-for-difference regime for renewables driving the creation of green projects and companies that need capital, enlightened supervision from the Bank of England and other UK financial regulators encouraging the adoption and use of green finance, and vibrant civil society actors creating demand for green products and services.

We are still in the early stages in the race for primacy in green finance. The UK can become the preeminent provider and organiser of capital and financial services to support this global transformation towards global sustainability and resilience. It could also lose out to much more determined and innovative competitors.

The UK Green Finance Strategy published in 2019 set out some important steps the UK Government could take to help realise its ambition in this area, including in relation to climate and nature-related financial disclosures, investments in new data and analytics capabilities, and support for new initiatives to help catalyse investment. The Green Finance Roadmap published in 2021 before COP26 also set out new world-leading proposals, including mandatory net zero transition plans for all large companies and financial firms from 2023.

A refreshed Green Finance Strategy is due later this year building on the important 2019 and 2021 reports. The Green Finance Strategy 2.0 needs to go much further if we are to retain leadership in an increasingly competitive field to be the preeminent green global financial centre.

Here are some ideas that could help make the Green Finance Strategy 2.0 suitably ambitious:

1) **New vehicles and structures to raise capital** - We need to systematically review the barriers and potential incentives and regulatory changes required for the UK to become the best place for raising capital for the transition via new or existing vehicles and structures across all asset classes. There are a variety of different types of potential vehicle or structure, including YieldCo-type structures focused on winding down fossil fuel portfolios through to SPAC/blank cheque vehicles that could bring private companies public in a way that supports their transition. We need something like the UK Listings Review chaired by Lord Hill but for green capital raising and transition finance. This needs to move quickly and could be done in parallel to preparing the Green Finance Strategy 2.0.

2) **Sustainability-linked instruments** - Sustainability-linked bonds and loans can be one of the most powerful and potentially effective ways to drive the transition as they link a counterparty's cost of capital directly to its sustainability performance. We need to accelerate their deployment, but we also need to ensure they don't become a vehicle for greenwashing. The UK should be at the forefront of designing the best sustainability performance metrics within these structures and support their deployment and use. To spur the market and reduce the exposure of the public sector balance sheet to the risk of stranded assets, all finance above a certain size from UK public financial institutions (e.g., UKIB, UKEF, BBB, and BII) should become conditional on meeting ambitious pre-determined sustainability objectives. UK green gilts could also become sustainability-linked. Green 'use of proceeds' bonds make little if any difference to real world outcomes and we need to embrace the next generation of green debt instruments.

3) **Net zero arbitration** – Legal services underpin UK finance, and the UK should aim to become the global centre for net zero mediation and arbitration. We first need to encourage the introduction of new net zero mediation and arbitration clauses in contracts between private parties. For example, a company might introduce such clauses as part of a supply chain contract, essentially saying they require their suppliers to have a net zero target and that this needs to be credible, and if this is disputed it would go to mediation and arbitration. Firms must already commit to net zero to win major UK government contracts, but what if these commitments aren't credible? Mediation and arbitration clauses would help ensure they were. One could imagine such clauses being introduced in a wide range of contracts. The London Court of International Arbitration and the Chartered Institute of Arbitrators should be at the heart of these efforts. The UK should aim to be the jurisdiction of choice for net zero mediation and arbitration, which will drive demand for UK climate expertise and lock-in UK legal services into areas set to grow rapidly.

4) **The best taxonomies** - The EU including natural gas in its green taxonomy was a strategic error in all sorts of ways. As a result, an already suspect EU green taxonomy has all but lost its credibility in the market. We now have an opportunity to ensure the UK is the go-to jurisdiction for trusted science-based taxonomies that work. We need a new brown taxonomy that defines the polluting activities that need to be phased out and by when. Through a new

adaptation taxonomy we can support the market identify investments that contribute positively to societal adaptation and resilience, as well as those investments that increase maladaptation and fragility, and help companies to become both more resilient and contribute more to resilience over time.

5) **Carbon removals** - the ‘net’ in net zero is essentially scrubbing carbon from the atmosphere at sufficient scales to address the residual emissions that we can’t currently mitigate. We will need to invest in carbon removal technologies and deployment infrastructures at immense scales, including to eventually reduce atmospheric concentrations of CO_2. We need to ensure policies, such as net zero-aligned emissions trading schemes, can motivate the investment required into carbon removals over the long term. We also need to ensure carbon removal projects can access capital markets quickly and efficiently at various stages of technological development and deployment.

6) **Nature recovery** - We need new funding mechanisms, operating at global scales, to pay for activities that protect and restore nature. These will need to remunerate outcomes in ways that are lowest cost, transparent, accountable, and verifiable. In the same way we need bankable, investable and insurable cash flows for carbon removals, we need these urgently for nature conservation and restoration. We also need to use private capital in innovative ways to maximise the impact of finite public and philanthropic funds. The UK can create and help deploy innovative and scalable nature recovery financing architectures globally. It can also be the first to design and deploy nature recovery transition plans, in a similar way to its pioneering work on net zero transition plans.

7) **Nature metrics** - The availability of suitable nature-related data and analytics that can be used across portfolios in covering different sectors, geographies, and asset classes remains nascent. We need a step change in activity to ensure these are available to market participants quickly, and that these actually work and aren’t shoddily put together black box methodologies. The UK has world-leading environmental science expertise that can be quickly marshalled to underpin the rapid integration of nature-related financial risks and externalities into financial decision-making globally. There is a strong case for urgent public funding in this area.

8) **Adaptation finance** - Adaptation investments reduce known (and unknown) future damages, and adaptation investments today can deliver growth, improvements in productivity, and potential “win-wins” for climate mitigation and nature recovery. We urgently need to front-load public funding into UK climate adaptation and resilience using capital markets. We also need to create demand for adaptation investments from companies. Embedding adaptation into mandatory transition plans would be one effective way to do this.

9) **Spatial finance** - To green finance and the financial system, better geospatial data is needed to measure a) the impacts that investments have on the local and global environment, as well as on sustainable development and b) the stranded asset risks investments face from different physical and transition risks related to environmental change. Analogous to the Human Genome

Project, the UK should lead the way in sequencing the physical economy to produce universally trusted, transparent, and verifiable datasets covering every physical asset on earth. This comprehensive digital map of all physical assets tied to ownership information will unlock new climate and environmental analytics, bringing geospatial data into financial analysis.

10) **Open data standards** – Companies and households are unable to easily share climate and broader environment-related data with financial institutions. This needs to change and the UK should pioneer the creation of new open environmental data standards, in a similar way to its pioneering design and use of the open banking standard. This would significantly reduce reporting burdens, create opportunities for product innovation, and improve the measurement and management of climate and environmental risks and externalities across the financial sector, especially in banking.

11) **Principles-based regulation and common law approaches** - The UK, together with other common law jurisdictions, should build a coalition in favour of principles-based approaches to regulating financial services, including but not limited to green finance. The first step should be to commission a short review examining how principles-based approaches to financial regulation can be improved, adopted, and applied to new areas of finance, including green finance, and how principles-based approaches in green finance can best work with rules-based ones.

12) **Aligning Quantitative Easing (QE) with net zero** - QE has provided capital in primary and secondary markets to support fossil fuel expansion, creating further carbon lock-in and increasing the risk of stranded assets. When the next crisis hits, QE will almost certainly be deployed as it has morphed from "unconventional" into very "conventional" monetary policy. To some, "greening" QE means only purchasing green assets, while others argue it means simply integrating climate and environmental risk assessments into asset purchases. Both interpretations have challenges. Before QE is deployed again at scale, the Bank of England should work to establish new norms and practices for QE to ensure it can actually support global environmental sustainability, while also efficiently meeting core monetary policy objectives.

The above ideas are by no means exhaustive but highlight some of the things that could be done to mark a significant step-change in UK green finance efforts. They would create new opportunities for continued UK leadership on green finance and would ultimately help the UK to scale its support for a necessary global transformation already well underway.

Dr Ben Caldecott is Director of the Oxford Sustainable Finance Group and the Lombard Odier Associate Professor of Sustainable Finance at the University of Oxford. He is also Director of the UK Centre for Greening Finance & Investment (CGFI).

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