HM GOVERNMENT: UPDATE TO GREEN FINANCE STRATEGY

CALL FOR EVIDENCE

SUBMISSION BY THE FINANCIAL INCLUSION CENTRE

About The Financial Inclusion Centre

The Financial Inclusion Centre is an independent, not-for-profit policy and research group (www.inclusioncentre.org.uk). The Centre's mission is to promote a financial system and financial markets that work for society. The Centre works at two main levels:

Promoting system level change

Research and policy development to promote sustainable, resilient, economically and socially useful financial markets that: benefit the environment; encourage responsible corporate behaviours and create a positive social impact; and efficiently allocate long term financial resources to the real economy.

Ensuring households' core financial services needs are met

Promoting fair and inclusive, efficient and competitive, well-governed and accountable, properly regulated financial markets and services that meet households' core financial needs. We do this by undertaking research into the causes of market failure in the sector, formulating policies to address that market failure, developing alternative solutions where the market cannot deliver, and campaigning for market reform.

For further information on our work in this field or on this specific submission please contact:

Mick McAteer
Co-Director
Financial Inclusion Centre
mick.mcateer@inclusioncentre.org.uk, or mickmcateer92@gmail.com

INTRODUCTION

We are pleased to respond to this important call for evidence. We have not been able to respond to all the questions in the call for evidence as some are outside of the scope of our work. In our submission, we focus on the role of UK policymakers and regulators (financial stability, prudential, market, and conduct of business) in aligning financial system and market behaviours with climate objectives. We are concerned that the legislative and regulatory framework, and specific regulations, rules, and guidance are not fit-for-purpose and will not drive the necessary change in the financial system and markets. A different approach will be needed if the UK is to be a leading effective, trusted, and reputable global centre of green finance.

For further details on our work in this area, we have a dedicated section of our website. See: [Financial markets, climate change, economic and social utility | The Financial Inclusion Centre]

RESPONSES TO QUESTIONS

HEADLINE QUESTIONS

1. What are the key characteristics of a leading global centre for green finance?

A leading global centre for green finance (GCGF) should be built around the following principles:

Effectiveness, efficiency, and neutrality We argue that the key objectives of climate related financial reform should be to: i. effectively align the behaviours and activities of the financial system,[1] markets, and institutions with climate goals; and ii. efficiently direct resources *to* climate positive economic activities and *away from* climate damaging activities. For this to happen, financial policy and regulation must be as efficient as possible in: i. causing financial institutions to disinvest and divest from their existing ***stock***[2] of climate damaging assets; and ii. ensuring the ***flow*** of new funding (public and private)[3] is allocated to climate positive economic activities and directed away from climate damaging activities.

Greening the financial system and underlying real economy will require sustained efforts over the long term. Therefore, it is important that any redirection of resources is sustainable and available funding is aligned with the long term in nature of climate goals. This will be a challenge given the short termism prevalent in UK financial markets.

The principle of neutrality is critical. Obviously, private finance will need to be harnessed in the appropriate way if we are to meet climate objectives. But, we argue it would be a policy error to design a green finance strategy deliberately biased towards leveraging private finance. As we explain below, state provided funding can be more efficient and appropriate to the challenge than private

[1] When we refer to the financial system, we include institutions of the state and the Bank of England, not just private sector institutions
[2] Held in the form of loans provided to and shares and bonds held in listed/ tradeable companies or larger privately owned companies
[3] When we refer to climate related funding or financial resources we include state/ public funding not just market based private finance (eg. banks, insurers, pension funds, asset managers, private equity and so on)

finance. The green finance strategy should be neutral and select the most effective and efficient forms of climate funding, not accord preferred status to one particular form.

Genuine financial innovation Market behaviours and the financial products and instruments produced in a GCGF should make a measurable, genuine contribution to climate objectives. Note that financial innovation *per se* is not the same as environmental, economic, and social utility. Growth in new products or an increase in green branded financial market activity should not necessarily be taken as evidence of environmental, economic and social utility.

Stable and systemically robust The link between climate change and i. systemic risks in the financial system; and ii. risks to specific financial institutions is now beginning to be understood. A successful GCGF should promote financial system and market behaviours that contribute to environmental, economic, and financial system stability (in the UK and, given the importance of the UK financial sector, globally). But, the proposals for climate related financial regulation does not fully recognise those risks. See below.

Integrity and trustworthiness A GCGF should be a beacon of integrity, transparency, and good corporate governance. It should compete by operating to the highest standards, not by promoting a race to the bottom on regulation. Quality is more important than quantity of business attracted. The GCGF should attract market participants who make a genuine contribution to climate goals and operate to the highest standards of integrity, and deter those who do not.

Users (domestic and global) of the GCGF should be able to have a high degree of confidence and trust in UK financial system, markets, and financial institutions – and that confidence and trust should be justified.

Well regulated and accountable A world class GCGF will require world class climate related financial regulation (financial stability, prudential, market, and conduct of business) and the highest standards of corporate accountability. As we explain elsewhere, the current approach followed by the government and financial regulators will not produce world class climate related financial regulation or the necessary corporate accountability. We urgently need to rethink and improve the proposals currently on the table for prudential, market, and conduct of business climate related regulation in the UK.

Crucial to effective regulation will be regulatory independence. We are very concerned with the direction of travel evident in the proposed reforms of the UK financial regulatory system post Brexit. The intention of the government to i. give the financial regulators a 'competitiveness' objective; and ii. allow HMT to require the regulators to change their rules, if government thinks it is in the public interest, threatens to compromise regulatory independence. Regulators should be free to ensure that quality of business takes precedence over quantity of business.

The principles of transparency and openness should be embedded into the operations of a GCGF. This requires moving away from prevalent regulatory culture in the UK which limits transparency to protect commercial interests.

The lessons from the financial crisis in 2008, tells us that trustworthy market and regulatory data and information is critical to preventing crises. The same will apply to managing the climate crisis. The climate related data and information employed all along the financial supply chain (for example, the

foundational taxonomy, investment labels, and ratings systems) must be trustworthy, relevant, and useful.

2. Do you consider the UK's green finance regulatory framework to be world-class?

No.[4] If we are to fund[5] the necessary green transition, we need:

- The appropriate high level policy framework for determining how best to fund the green transition (specific legislation and regulation relating to green finance has to flow from the high level policy framework).

- An effective legislative and regulatory framework to align the financial system and markets with climate goals covering financial stability, prudential, conduct of business, and financial reporting and disclosure regulation.

- Detailed, effective regulatory policies, regulations, rules, and guidance operated by the main regulators - The Bank of England (BoE), Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA), The Pensions Regulator (TPR), and Financial Reporting Council (FRC). Effective regulation must: i. **direct** private sources in its various forms *to* climate friendly economic activities and *away from* climate damaging economic activities; and ii. promote the right behaviours and activities in financial markets (including tackling greenwashing).

- The climate related data and information employed all along the financial supply chain (for example, the foundational taxonomy, investment labels, and ratings systems) must be trustworthy, relevant, and useful. A robust, meaningful foundational taxonomy is particularly important. This should: i. make it clear which economic activities are climate supporting (green) and climate damaging (brown); and ii. allow for assessment of the contribution each part of the financial supply chain makes to the green transition. Effective financial stability, prudential, conduct of business, and financial reporting and disclosure regulation can only be built on a robust, trusted foundational taxonomy.

- The right culture and approach adopted by the relevant regulators to ensure those policies, regulations, rules, and guidance are implemented. Tackling the climate crisis will require a precautionary approach to financial regulation using robust *ex ante* interventions to direct markets, not the permissive market-orientated approach hitherto favoured by UK financial regulators.

At each of those levels of policymaking, the UK is lacking. For more detail on this, please see Financial Inclusion Centre report *Time for Action*.[6] The report identifies a range of structural, market, institutional, infrastructure, and regulatory issues that are preventing the alignment of financial market activities and behaviours with climate goals.

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[4] Note that we do not consider that any particular international jurisdiction has implemented the appropriate policy and regulatory framework. But, in comparative terms, the UK is failing on key aspects.

[5] 'Fund' throughout our response refers to the range of funding mechanism including: public and private sources; different forms of funding including investment, lending, blended finance; direct charges and taxes.

[6] [Time for Action – Greening the Financial System | The Financial Inclusion Centre]

The high level policy framework

With regards to funding the necessary green transition, there have been a number of attempts to model the level of funding needed for the UK to meet its net zero goals.[7] Moreover, The Committee on Climate Change (CCC) has undertaken detailed analysis of the level of funding needed within specific economic sectors.[8]

So, we have reasonable estimates about how ***much*** is needed. But, we do not have the political structures and high level policy mechanisms to ensure the necessary level of funding occurs. The UK, despite the stated commitments of government, is falling behind in terms of the level of funding needed.[9]

There has been little detailed analysis (and even less informed transparent public debate) on how ***best*** to fund the transition. That is: what is the most sustainable and economically efficient means of funding the transition; how to achieve a just and fair transition; and how, where, and when to best deploy available funding to different sectors of the economy (public and private).

There are big decisions to be made such as on the balance between: public and private sources of funding; and direct charges, current taxation, and borrowing. There are difficult choices to be made about intergenerational fairness. The timing of funding decisions is also important. There are decisions to be made on which type of funding is most appropriate for specific sectors of economy (public and private); and the balance between central and local government funding.

We must also consider the impact of *economic* policy decisions made by policymakers on green transition policies. For example, decisions by the MPC to raise interest rates to tackle inflation has consequences for funding green tech which becomes comparatively more expensive.[10]

We do not have the appropriate policy framework in place to allow us to answer those critical questions in the national interest. So far, the government's attention seems to have been focused on incentivising private finance in its various forms (eg. pension funds, insurance funds, private equity and so on) even though private finance is a more costly form of funding than collective funding through the state. These decisions are important. Defaulting to more costly forms of funding has real world consequences. It feeds through to higher costs for households.[11]

An effective legislative and regulatory framework

It is not at all clear that policymakers and regulators recognise in the policies they propose the financial risks associated with climate change – particularly the impact on households. The UK, with its heavily financialised economic system is particularly exposed to climate-related financial risks. [12]

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[7] The OBR estimated that £1.4 trillion in additional investment would be needed between 2020 and 2050 for the UK to meet its domestic net zero emissions targets How much will it cost the UK to reach net zero? | Financial Times (ft.com) The-Sixth-Carbon-Budget-The-UKs-path-to-Net-Zero.pdf (theccc.org.uk)

[8] Sixth Carbon Budget - Climate Change Committee (theccc.org.uk)

[9] Climate: WWF warns UK spending is lagging behind targets - BBC News

[10] Can we avoid green collateral damage from rising interest rates? | by UCL Institute for Innovation and Public Purpose | UCL IIPP Blog | Jun, 2022 | Medium

[11] Private finance demands a return above the 'risk free rate' namely government bonds (gilts). Higher charges need to be extracted from households to pay for the higher returns expected.

[12] See: People in US and UK face huge financial hit if fossil fuels lose value, study shows | Fossil fuels | The Guardian
Stranded fossil-fuel assets translate to major losses for investors in advanced economies | Nature Climate Change

Dealing with these financial risks requires a sustained, robust approach to financial market regulation. But, for regulation to be effective also requires the appropriate legislative framework.

With regards to the overarching legislative and regulatory framework, we highlighted in our report, Time for Action, that the absence of clear, primary statutory objectives for financial regulators in relation to climate change is a major barrier to greening the financial sector - and therefore greening the economy.[13]

Therefore, we propose that the Bank of England should be given new statutory objectives to promote financial market behaviours that contribute to economic and environmental sustainability; and, specifically, to ensure the activities of the UK's financial sector are aligned with the goal of 1.5 degrees of warming. The FCA, PRA, TPR, and FRC should be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objectives.

The FCA should be given responsibility for overseeing how financial institutions, listed companies and larger private companies disclose compliance with sustainable, responsible, and social impact (SRI) criteria. The FRC should retain responsibility for ensuring the auditing of underlying economic activities meet regulatory requirements. Reporting on SRI compliance should be made a statutory requirement rather than voluntary, with appropriate sanctions for non-compliance with reporting standards.

There needs to be greater focus on supply chains in the economy.[14] The FRC and FCA should collaborate on improving the standards of auditing in and reporting on compliance with climate goals in supply chains.

Government and Bank of England should establish a Financial Sustainability Committee (FSC) along the lines of the Monetary Policy Committee (MPC). The FSC should take responsibility for the Bank's new statutory objective described above and coordinate the work of all the regulators involved in managing climate related risks – the Bank of England, PRA, FCA, and The Pensions Regulator (TPR).

The FSC should publish an annual report on its activities plus a wider triennial review on progress against its objectives. The FCA, PRA, and TPR should also publish an assessment in their annual reports on how their activities have contributed to the objective of the FSC.

Detailed regulations, rules, and guidance

We also have concerns about the detailed regulations, rules, and guidance currently proposed by the main regulators. These are not as well developed as other jurisdictions. A good example relates to how the UK is falling behind the EU in developing a robust green finance taxonomy.

We do not have the space to cover all the current legislative and regulatory reforms in train. But, we would highlight the reforms to Solvency II, aligning bank behaviours, and the FCA's proposals on disclosure and investment labelling.

[13] Time for Action – Greening the Financial System | The Financial Inclusion Centre

[14] The supply chain accounts for more than 90% of most consumer goods companies' environmental impact. For more detail see: Podcast: The Devil is in the policy detail – the role of disclosure and reporting, standards setting bodies, and audit and accountancy professions | The Financial Inclusion Centre

Government, post Brexit, is currently consulting on reforms to Solvency II.[15] The government appears to believe that, by reforming Solvency II, the insurance industry will be incentivised to direct more resources to green assets. Specifically, it wants to change the way a technical provision called the Matching Adjustment is calculated. The Matching Adjustment is a perverse mechanism that allows insurers to discount liabilities to the benefit of shareholders. The government's proposals are not an economically efficient way to direct resources to green assets.

Moreover, we are very concerned that government's intentions will lead to a reduction in consumer protection for policyholders and pension savers[16] while providing a further windfall for shareholders.

In a nutshell, government's approach on Solvency II can be summarised as reducing consumer protection, offering shareholders the chance of a windfall, and risking taxpayers money - all just to encourage a costly way to fund the green transition.

Moreover, this approach does not actually recognise the scale and nature of climate related financial risks. It would be much more effective for Bank of England/ Prudential Regulation Authority to ***direct*** insurance and pension resources to climate positive activities (green assets) by deterring funding of climate damaging activities (brown assets).

To do this, regulators will have to deal with the ***stock*** of existing climate damaging assets and the ***flow*** of new funding and resources. And if this redirection of resources is to happen efficiently and effectively, financial regulators will need to ensure that insurers (and banks and asset managers) have credible and demanding transition plans in place with clear targets and timeframes.

Once transition plans have been approved, specific policy tools will be needed to implement these plans. We very much support the idea that policymakers and insurance prudential regulators should adopt the "One for One" Rule. That is, for each £ of resource that finances ***new*** climate damaging activities, insurers should hold a £ of their own-funds held liable for potential losses.[17] An alternative would be to adjust the 'own-funds requirement' by reference to an independent assessment of the climate damage caused by an economic activity.[18]

That would address the ***flow*** of new funds. We would still need to deal with the ***stock*** of existing climate damaging assets. This could be done by requiring insurers to hold a proportion of own-funds against existing holdings – this proportion would be increased over an appropriate time frame to incentivise insurers to divest these assets in line with the transition plans described above.

Similarly, there have been arguments put forward by industry lobbies that charge caps on pension schemes could be relaxed to 'facilitate' investment in green finance infrastructure and levelling up. Again, we believe that the real aim here is allow private finance to generate higher returns and higher fees (greater value extraction). Undermining an important consumer protection measure to facilitate a more costly form of funding does not make sense.

As mentioned above, private finance (including via insurance funds and pension funds) is a costly way to fund green infrastructure. Diluting critical pieces of legislation and regulation, which would

[15] The PRA is also consulting on the details but there is no question this reform is being driven by the Government.
[16] There are concerns that the use of the Matching Adjustment already artificially inflates the strength of the balance sheets of a number of major UK insurers. See: Regulation is masking the true condition of insurers | Financial Times (ft.com)
[17] https://www.finance-watch.org/the-one-for-one-rule-a-way-for-cop26-ambitions-to-manifest-in-policy/

[18] But, this would require a robust foundational taxonomy which we do not have

reduce consumer protection, just to encourage more costly forms of funding green infrastructure does not make sense in policy terms.

Moreover, we also note that the finance industry is lobbying for the state to 'de-risk' green assets (such as new green technologies or green infrastructure) by underwriting the associated early stage risks. This is what is known as 'socialising the risks, privatising the rewards'. Again, it does not seem to be an economically sensible approach.

Similar issues arise with regards to prudential regulation of banks (although it is worth noting that banks do not benefit from the perverse matching adjustment incentive available to insurers). We would argue that the One-for-One Rule outlined above should also be adopted for calculating Pillar 1 capital requirements for banks.

Conduct of business regulation, information disclosure

With regards to conduct of business regulation, the FCA is relying heavily on improving disclosure and transparency. The FCA wants to introduce a tiered approach to disclosing information. This is appropriate as different external users of relevant data and information (such as investors, pension funds, civil society) will need to have access to (or be interested in) different levels of component data.

But, we have serious concerns about the classification system proposed by the FCA.[19] The classification system proposed is not robust and could result in confusion. In particular, the low level criteria that financial institutions would have to meet to be allowed to market and promote their funds and products as 'Responsible' and 'Sustainable' could lead to greenwashing, misselling, misrepresentation, and investors inadvertently making poor financial decisions.

We are also very concerned about the lack of detail on how the FCA will supervise compliance with its rules and how claims made by financial institutions are to be independently audited to ensure that any label or rating system is not built on misleading foundations.

In addition, we have concerns about the proposals for auditing real economy firms' compliance with climate disclosures.[20]

The absence of a robust foundational taxonomy must be urgently addressed if financial stability, prudential, conduct of business, and reporting and disclosure regulation is to be effective.

Regulatory culture and approach

The dominant culture and attitudes within the UK regulatory system is a cause for concern. UK regulators are relying far too much on disclosure, transparency, and 'encouraging' the market to achieve the necessary realignment of market behaviours and activities.

[19] Financial-Inclusion-Centre-submission-to-FCA-dp21-4-final.pdf (inclusioncentre.co.uk)
[20] Podcast: The Devil is in the policy detail – the role of disclosure and reporting, standards setting bodies, and audit and accountancy professions | The Financial Inclusion Centre

UK financial regulators do not appear to be as willing to take action against financial firms suspected of 'greenwashing' as their US counterparts.

Historically, UK financial regulators have tended to follow a permissive approach to regulation, intervening only when there is evidence of harm that cannot be ignored. This is not the appropriate approach to climate risks. We cannot afford to wait. Therefore, we urge the financial regulators to adopt a precautionary approach to climate related financial regulation.

Financial market behaviours will only align with climate goals if financial institutions are made to fully appreciate and recognise the cost of failing to do so. The experience of repeated financial scandals and crises tells us that we cannot rely on the market dynamics to reveal and 'signal' the true cost of market failure or compel financial institutions to respond.

It will require ***direction*** from policymakers through the appropriate legislative framework, statutory objectives provided to regulators, and robust pre-emptive and precautionary interventions on the part of regulators that ***deter*** climate damaging financial activities.

3. To what extent does the UK's private and public sectors have appropriate skills/capacity to attract international green finance flows?

The issue here is not whether the UK contains skills/ capacity to attract international green finance flows. The UK undoubtedly contains institutional capacity and professional expertise to attract green finance flows. It has a well-established track record in financial 'innovation' – even if much of that innovation added little by way of genuine economic and social utility.

Rather, the issue is: on what terms might the UK attract international green finance flows? As outlined above, we are concerned about the government's post Brexit deregulatory agenda – including the intention to give financial regulators a 'competitiveness' objective. We would urge the government to compete for green finance flows on trustworthiness, integrity, and high standards. The UK should be a beacon for those seeking the highest standards in the fast developing green finance sector.

4. What are the UK's comparative strengths and weaknesses in its green finance offering compared to other international financial centres? What are these are for:

a) Asset management; b) Capital markets; c) Banking; d) Insurance; e) Professional services; f) Fintech

No comment.

5. How can the UK government measure progress towards becoming a leading global centre for green finance?

The temptation would be to measure success through the level of and growth in green finance activities conducted in the UK. This would not be appropriate. The appropriate way to measure progress is to develop meaningful metrics to assess how well the UK as a global centre for green finance complies with the characteristics outlined in the response to Q1.

6. What areas for potential growth – for example emerging financial products and instruments – are there in green finance for the UK financial services sector?

We have no comment on specific products and instruments. The right products and activities will emerge given the right legislative and regulatory framework. Clearly, private finance in its various forms (pension funds, insurers, private equity and so on) will play a significant role in driving the green transition. The challenge for policymakers is how to ensure this is done in the most sustainable and economically efficient way.

As important as potential growth in green finance products is ensuring that private finance stops funding climate damaging activities. Similarly, as mentioned above, success should not be measured just in terms of growth. Quality is as, if not more, important than quantity.

More importantly, see above, is the lack of a policy framework for determining the most efficient and effective mechanisms for funding the green transition. As we describe elsewhere, so far, the government's attention seems to have been focused on incentivising private finance even though private finance is more costly than state funding mechanisms.[21] It would be beneficial to national climate policy goals if the government and state agencies such as the Bank of England and National Infrastructure Bank devoted more time and resources to identifying supportive state based funding models.

FINANCING THE UK'S ENERGY SECURITY, CLIMATE AND ENVIRONMENTAL OBJECTIVES

7. How can the UK support a financial system that leverages private investment to meet the UK's climate and environmental objectives?

In our view, this is the wrong way to frame the challenge. The priority question to address is, not how to support and leverage private investment, but how to determine the most effective and efficient funding mechanisms and the balance of funding between public and private sources. It would be a serious policy error to design a legislative and regulatory system to encourage costly private finance which crowds out potentially more efficient and supportive state funding (See principle of neutrality, above).

As outlined above, rather than prioritising leveraging private finance, we need appropriate legislation and regulation that causes private finance to disinvest and divest from climate damaging economic activities and deters future funding of climate damaging activities.

There are some positive interventions which could be deployed to generate climate supporting financial behaviours. For example, we support the proposals outlined by Positive Money for the Bank of England to use its market influence:

- **Green Term Funding Scheme**: The Bank of England should use the framework of preferential interest rates to incentivise green lending.[22] A Green Term Funding Scheme would enable

[21] Private finance demands a return above the 'risk free rate' namely government bonds (gilts). Higher charges need to be extracted from households to pay for the higher returns expected.
[22] https://www.bankofengland.co.uk/markets/market-notices/2020/term-funding-scheme-market-notice-mar-2020

financial institutions with green lending activities to borrow money from the Bank at a lower rate and support longer term green projects. However, for this to work, we would need to establish a foundational UK green taxonomy – see elsewhere for details.

- **Green collateral frameworks:** the Bank of England should deter financial institutions from holding brown assets. This could be done by reducing the value of these assets by excluding them as collateral or subjecting them to 'haircuts. The Bank could also increase the value of green assets by requiring a minimum quota of sustainable sectors to be held in credit portfolios.

8. How can the UK support a financial system that leverages private investment to meet the objectives of the British Energy Security Strategy, including in areas such as nuclear, hydrogen, carbon capture and storage and domestic oil and gas production, to reduce our reliance on imported fossil fuels as part of a smooth energy transition?

See above on the principle of neutrality. The challenge is framed best, not as prioritising the leveraging of private investment, but how to deploy the most efficient and effective funding mechanisms, including state funding, for meeting the objectives of the BESS. It could be said that this is all the more important when it comes to energy security. Private finance is not only more costly, but in the case of overseas private finance implies greater security risks.

9. What barriers are there to unlocking private investment to support the UK's energy security, climate and environmental objectives?

Again, we would suggest the government should not only be thinking in terms of 'barriers to unlocking private investment'. No doubt the government will receive many responses from the finance lobbies arguing that, if it is to provide the necessary private investment, it needs a 'supportive regulatory environment' (ie. deregulation), incentives, and de-risking/ risk underwriting/ subsidies provided by the state.

We do not need to risk deregulating the financial system and reducing hard won improvements in financial consumer protection, or the state to provide costly incentives/ subsidies/ de-risking, to unlock a form of investment which in itself is more costly and less sustainable and reliable than state funding.

Rather, it is for the government to develop the appropriate funding strategy, create the appropriate funding mechanisms, and legislative and regulatory framework and tools to channel the most efficient forms of sustainable funding (public and private) towards national policy objectives.

Perhaps the biggest barrier is the absence of a clear, coordinated funding strategy to support national energy security, climate and environmental objectives. There appears to be no strategy that determines the right balance of funding between public and private sources, and how and when to best deploy private funding.

Looking specifically at the current approach to *policy* and *regulation,* this is not a barrier in the sense that it is **blocking** the appropriate type and scale of funding reaching climate positive economic activities. However, it is failing to **channel** the necessary resources *towards* climate positive activities and *away from* climate damaging activities. The current legislative and regulatory framework, and specific regulations, rules, and guidance do not compel financial markets and institutions to fully recognise climate related risks in their activities and behaviours.

Private finance will, of course, need to play an important role in meeting national policy objectives. But, this can be best achieved by ensuring there is a penalty for continuing to fund climate damaging activities (whether by remaining invested in the current stock of climate damaging activities or providing new flows of funding to those activities – see above). In doing so, this would ensure that private financial institutions recognise the need to fund climate supporting activities.

10. How can the UK government assess and measure progress toward financing the UK's energy security, climate and environmental objectives?

First of all, the UK needs a funding strategy for these national policy objectives including sector (public and private) specific strategies. This strategy should set out the funding required to meet these national policy objectives and appropriate balance of funding between: public and private sources, taxation, charges, pre-funding and pay-as-you-go (PAYG), and investment and borrowing etc. This strategy then needs to be translated into detailed sector specific action plans.

Secondly, the government should develop a set of principles to be used to determine the most appropriate type and balance of funding required to meet those objectives (including sector specific principles). In terms of principles, this should include:

- **Cost**: it is obviously important that the government chooses the most cost effective form of funding priority national policy objectives. Otherwise, higher costs will be borne by households including future generations who do not have a say in these decisions.
- **Efficiency**: as well as cost, funding should be efficient – that is, it should be able to be mobilised efficiently to support national policy objectives.
- **Appropriateness and alignment**: certain types of funding will be more appropriate for specific policy objectives. In some cases, given the nature of the national policy objectives discussed here, the funding provided to an economic activity would need to be committed for a long time. It may be a significant length of time before that funding breaks even or produces a positive return – indeed, there is no guarantee that certain activities will produce a positive return. In other cases, funding out of current spending may be more appropriate. For example, a programme of insulating homes could be funded out of hypothecated taxes funded by an energy industry levy. So, the funding mechanism should be aligned with the nature of that national policy objective and specific economic activities.
- **Sustainability and security**: the national policy objectives discussed are long term in nature. To protect the national and public interest, the funding mechanisms should be sustainable and secure.
- **Just and fair**: as a non-profit organisation focused on economic and social justice, Financial Inclusion Centre is concerned that meeting national policy objectives and achieving the necessary green transition should be done in a way that is just and fair to economically vulnerable and disadvantaged households.

Therefore, in relation to assessing and measuring progress, the government should urgently develop, in consultation with civil society:

- a national funding strategy including how much funding is needed to meet national policy objectives;
- detailed specific sector action plans including how much funding is needed; and
- specific metrics to assess compliance with the principles outlined above.

The government should report publicly on progress against this national strategy with relevant government departments reporting against sectoral action plans.

The government should lead a new strategy to green the 'real economy'. Building on the work of the Committee on Climate Change (The CCC), government and relevant regulatory authorities should undertake a 'transformation audit' of the main economic sectors to assess the contribution each sector has made to the greening of the economy; and develop a transformation action plan for each sector. The government should establish a single agency to coordinate this strategy. This new agency, along with the National Audit Office (NAO) should develop new metrics to judge the performance of each sector, and publish annual updates and a formal triennial review of progress made against the transformation strategy.

11. How can the UK best facilitate greater private investment into climate change adaptation and resilience activities?

Our answers to Q7-9 also apply to this question.

FINANCING TRANSITION ACTIVITIES

12. Are there barriers to the mobilisation of private investment into transition activities? If so, what are they and how might they be overcome?

See our response to Q2 and Q7-9. The same issues apply. The legislative and regulatory framework and proposed detailed regulations, rules, and guidance are not fit for purpose to differentiate between green finance and transition finance, or to prevent greenwashing.

13. How can the UK become a leading hub in structuring and innovating on transition finance?

14. Is there a role for the UK government to support the development of transition finance markets in the UK and internationally?

See above answers to Q1-5. The approach and policies needed to make the UK a leading hub in transition finance are the same as those needed to make the UK a leader in reputable green finance.

DEVELOPING NATURAL CAPITAL MARKETS

15. How can the UK best support the mobilisation of private investment to natural capital assets?

16. How can the UK government best assess the progress and development of a natural capital investment market?

We have not looked closely at the issue of natural capital assets. But, we would presume that the issues we have identified in response to the above questions would also apply to this challenge.

ENSURING BROAD ACCESS TO GREEN FINANCE FOR LOCAL AUTHORITIES, SMES AND RETAIL CUSTOMERS

17. How can the UK financial sector support the delivery of the UK's climate and environmental objectives at the local level, whilst also benefitting local growth and communities?

The issue here is not so much how the financial sector supports the delivery of climate objectives at local level and benefits local growth and communities. Rather, it is how the government and regulators ensure that private finance is used in the appropriate way.

For example, as we explain elsewhere, the insurance lobby is claiming that Solvency II as currently constructed is inhibiting its ability to invest in green infrastructure and support 'levelling up'. But, Solvency II would not prevent insurers from investing in these activities. We believe the true objective of the lobbying is to reform Solvency II to provide a windfall to shareholders. Private finance (that is, finance designed to produce a commercial return) is a costly form of funding. Deregulating and reducing consumer protection just to facilitate a costly form of funding does not make sense.

Similarly, as explained, there have been arguments put forward by industry lobbies that charge caps on pension schemes should be relaxed to 'facilitate' investment in green finance and levelling up. Again, we believe that the real aim here is allow private finance to generate higher returns and higher fees (greater value extraction). Undermining an important consumer protection measure to facilitate a more costly form of funding this time through pension funds does not make sense.

Nevertheless, there are some positive measures the government could implement at local level. See next question.

18. How can local authorities support the mobilisation of private and public investment to key sectors and technologies for the UK's climate and environmental objectives, whilst also meeting local priorities? What barriers to this are there?

Local authorities do have a potentially significant role to play in meeting the UK's climate and environmental objectives and, in doing so, meet local priorities. But, there are a number of structural financial barriers limiting the ability of local authorities to play a full role.

- Central government should work with local government representatives to develop local area versions of the strategy and plans outlined in Q10 above.
- Central government should relax the constraints on local government borrowing to allow local authorities to raise greater levels of low cost funding from central government and households (in the form of green community bonds) as well as raising finance from the National Infrastructure Bank.
- We support the proposal from Positive Money that a targeted, specific form of QE should be implemented involving the Bank of England buying green local bonds to support local authorities' climate and environmental objectives.

19. What is the current state of capability within local authorities to attract investment, and how can it best be supported?

No comment.

20. How can the UK financial sector support SMEs and retail customers to align with the UK's climate and environmental objectives?

We limit our comments to retail customers. The most important actors in this are the government, financial regulators, and consumer protection agencies who are responsible for aligning financial market and real economy behaviours with climate goals.

If retail consumers are to play their role in meeting climate goals they need to have confidence and trust in the climate related behaviours of both the:

- **Financial system:** this includes the financial institutions that hold, manage, or steward their money, financial intermediaries that make decisions on their behalf or help them make decisions, and the information and data on which they base their decisions.
- **Real economy:** the firms that utilise the financial resources provided via the financial system in the form of loans, investment and so on.

To put it another way, the funds and products used by retail *financial* consumers are comprised of investments in, or loans to, real economy firms. So, if financial consumers (and institutions) are to make effective financial decisions, the data and information relating to both the financial products and underlying real economy firms must be trustworthy and accurate.

With regards to the financial system, we have serious concerns about the approach the government and financial regulators are taking to the regulation of financial institutions and various financial intermediaries – see above.

Overall, we are very doubtful that the current approach to financial regulation will engender consumer trust and confidence in financial markets, or help retail consumers make truly informed decisions and choices. This should be a real cause for concern. Harm follows the money in financial services - as the litany of misselling scandals which have left a legacy of mistrust demonstrate. There are significant sums of money now going into financial products branded as 'green' or climate friendly. It must be obvious that the risk of greenwashing is very high and that a much more robust approach to regulating financial markets and institutions is needed to promote and maintain consumer confidence.

With regards to real economy firms, the Competition and Markets Authority (CMA) has developed a Green Claims Code to 'help businesses comply with the law'. But, the CMA says little about how breaches will be enforced against. Codes *per se* are a light touch form of regulation, and do not have a good track record in constraining poor practices in key economic sectors. But, using a code is all the more surprising given that the CMA working with other global authorities found that 40 percent of green claims made online could be misleading suggesting that thousands of businesses could be breaking the law.[23]

[23] Greenwashing: CMA puts businesses on notice - GOV.UK (www.gov.uk)

We would argue that the CMA should adopt a more robust approach to supervising behaviours and enforcing against breaches in the real economy. This should include the supply chains of key consumer sectors – as mentioned, the supply chain accounts for more than 90% of most consumer goods companies' environmental impact.

21. Is there a role for the UK government to facilitate broad access to green finance for local authorities, SMEs or retail customers? If so, what should these roles be?

See above. It is not a question of facilitating broad access to green finance *per se*. The key role for the government is to work with financial regulators to ensure that users of financial products and services can have confidence and trust in those products and services, institutions, and intermediaries that supply and provide access to them.

HIGH INTEGRITY VOLUNTARY MARKETS FOR CARBON AND OTHER ECOSYSTEM SERVICES

22. How can the UK best support the development of high integrity voluntary markets for carbon and other ecosystem service markets?

No comment.

23. How can we ensure that these markets encourage robust action on the UK's climate and environmental goals, and appropriately scale up finance flows to support these?

No comment.

24. How should the UK harness the economic opportunities associated with high integrity growth in voluntary carbon markets and ecosystem services markets?

No comment.

25. How can UK environmental and economic regulators increase demand for high quality, accredited ecosystems services?

No comment.

GREENING THE FINANCIAL SYSTEM

26. What are the key characteristics of a Net Zero-aligned Financial Centre? How would these characteristics apply to a typical UK-based:

a. Bank; b. Insurer; c. Asset manager; d. Regulated asset owner; e. Listed company; f. Large private company; g. Small and medium size enterprise (SME); h. Retail investor; i. Professional services firm; j. or any other relevant industry participant

A world class UK based Net Zero-aligned Financial Centre (NZFC) should be built around the same principles outlined in Q1: efficiency, effectiveness, and neutrality; genuine financial innovation; stable and systemically robust; integrity and trustworthiness; well regulated and accountable.

We are unclear as to why the consultation separates out the different types of financial institution and actors in the financial system – see a-j. The principles outlined above should apply to all parts of the financial system and supply chains. Of course, specific regulations and rules will be more relevant to specific parts of the financial system eg. insurance, pension funds, or banks.

27. What market barriers are there to the integration of environmental-related factors into financial decision-making?

For a full explanation of the barriers, please see Financial Inclusion Centre report Time for Action.[24] We summarised these barriers into:

- **Specific nature of projects** Long payback periods and the perceived higher risk of climate positive assets can be unattractive to risk averse, short-termist financial institutions and markets.
- **Institutional factors** A range of factors including the type of liabilities institutions face, tolerance to risk, and the need for liquidity reduces the *viable* pool of resources available.
- **Financial regulation** As described above, the current approach to climate related financial regulation (financial stability, prudential, market, and conduct of business including information related) will not be sufficient to align financial market behaviours.
- **Information and perception barriers** There is a lack of clear definitions and criteria for determining whether an economic activity complies with climate goals. Moreover, we lack independent sources of data free from conflicts of interest, and trustworthy benchmarks and consistent ratings to judge how well financial activities comply with climate goals criteria. Data and research on risks and rewards associated with climate assets is still very limited. The amount of effort and cost required to identify potential opportunities can deter financial institutions and retail consumers. The absence of a foundational taxonomy is a significant barrier.
- **Limited market infrastructure** This includes a lack of an appropriate primary and secondary market infrastructure for raising capital and trading of climate assets, and collective investment vehicles for managing the risk of investing in smaller scale climate projects. But, promoters face a catch 22 situation. Sufficient resources are unlikely to be committed to developing the necessary research base and infrastructure unless those asset classes become more popular. But, those asset classes are unlikely to become mainstream without the necessary research and supporting infrastructure. This is a particular problem for smaller or early stage green ventures.
- **Dominant culture of short termism and shareholder value** Market short-termism is at odds with the long payback periods associated with direct investment in climate supporting activities, and is a constraint on listed companies who wish to spend time and money 'greening' their operations. Greening the UK economy will require significant investment in research and development (R&D). But the UK has a low level of spending on R&D and corporate investment compared to other major economies. The emphasis on shareholder value appears to lead to lower levels of investment and holds back innovation.

[24] Time for Action – Greening the Financial System | The Financial Inclusion Centre

- **Limited availability of suitable green ventures** The lack of viable green ventures creates a natural barrier restricting the amount of finance that can be channelled into economic transformation.
- **Other market factors** Passively managed funds now represent 25 percent of total UK assets under management in UK. Passive funds automatically include shares of companies from energy-intensive sectors in their portfolios, and are not actively managed so fund managers do not seek out potential opportunities not listed on markets. Investment consultants influence investment and asset allocation decisions on £1.6 trn of pension assets (out of a total of around £2 trn). Similarly, nearly 80 percent of money managed on behalf of retail investors is done on an advised basis. Persuading these influential gatekeepers of the merits of climate positive financial activities will be a priority.

28. What should the role of the UK government or regulators be to support the greening of the financial system? How could they go further?

The role of the Government and regulators is to ***make*** the financial system and markets work so that they support climate objectives, not to 'create the conditions' for the market to do so.

This means addressing the issues and barriers identified above in Q26/ Q27. For example, only the government and regulators can create the necessary infrastructure to green the financial system and markets or address the lack of trustworthy and reliable research, data, and information. Moreover, unless the underlying real economy is 'greened', there will be limited opportunities for financial markets and institutions to support – this risks creating green asset price bubbles.

The right approach to financial regulation will be critical. As we explain elsewhere, if the financial system and markets are to be greened, we need:

- An appropriate high level policy framework for determining how best to fund the green transition (legislation and regulation relating to green finance must flow from the high level policy framework).

- An effective legislative and regulatory framework to align the financial system and markets with climate goals covering financial stability, prudential, conduct of business, and financial reporting and disclosure regulation.

- Detailed, effective regulatory policies, regulations, rules, and guidance by operated the main regulators to **direct** private sources in its various forms *to* climate friendly economic activities and *away from* climate damaging economic activities and to promote the right behaviours and activities in financial markets (including tackling greenwashing).

- A robust, meaningful foundational taxonomy which: i. makes it clear which economic activities are climate supporting (green) and climate damaging (brown); and ii. allows for assessment of the contribution each part of the financial supply chain makes to the green transition. Effective financial stability, prudential, conduct of business, and financial reporting and disclosure regulation can only be built on a robust, trusted foundational taxonomy.

- The right culture and approach adopted by the relevant regulators to ensure those policies, regulations, rules, and guidance are implemented.

29. How can the UK government measure progress towards greening the financial system?

This can be done in two ways. Firstly, it can create a framework to assess how well government and regulatory interventions are overcoming the barriers identified above in Q28. For example, it is possible to assess the quality and reliability of data, information, and research and judge whether progress is being made.

But, the most important measure of progress is the degree to which the necessary scale and ***appropriate*** type of financial resources is directed *to* climate positive economic activities and *away from* climate damaging economic activities.

We emphasise the term ***appropriate.*** Ensuring sufficient quantity of resources is directed to climate supporting activities is obviously important. But, care must be taken to measure the quality of those resources. As mentioned elsewhere, harm follows money in financial services. There has been a significant increase in the amount of investment and number of financial products branded as green or climate aligned. But, there is no objective comprehensive analysis of what proportion of that investment/ products are genuinely climate aligned. The risk of greenwashing is significant.

Moreover, greening the financial system and underlying real economy will require sustained efforts over the long term. Therefore, it is important that any redirection of resources is sustainable and available funding is aligned with the long term in nature of climate goals. Again, it is not enough to just measure the level of resource appearing to support climate supporting activities, the resource needs to be sustained and aligned with the long term nature of climate objectives.

PROVIDING THE MARKET WITH THE RIGHT DATA

30. What steps can the UK government take to support a robust investment data ecosystem to attract green finance flows?

There are a number of steps UK government and regulators can take to support a robust data ecosystem (note this is not just about investment data but also lending and other financial data).

As we explain elsewhere, there is a lack of clear definitions and criteria for determining whether an economic activity complies with climate goals. Moreover, we lack independent sources of data free from conflicts of interest, and trustworthy benchmarks and consistent ratings to judge how well financial activities comply with climate goals criteria. Data and research on risks and rewards associated with climate assets is still very limited. The amount of effort and cost required to identify potential opportunities can deter financial institutions and retail consumers.

Therefore, we recommend that government should convene stakeholders to collaborate on developing a central repository of information, research, and risk analysis on climate related finance. This should be accessible to financial institutions, regulators, pension trustees and citizen-investors.

Moreover, as outlined elsewhere, we have serious concerns about the approach the FCA is taking to sustainability and investment labelling.[25] The classification system proposed is not robust and could result in confusion. In particular, the low level criteria that financial institutions would have to meet to be allowed to market and promote their funds and products as 'Responsible' and 'Sustainable' could lead to greenwashing, misselling, misrepresentation, and investors inadvertently making poor financial decisions.

We are also very concerned about the lack of detail on how the FCA will supervise compliance with its rules and how claims made by financial institutions are to be independently audited to ensure that any label or rating system is not built on misleading foundations.

Therefore, for a new data ecosystem to attract sustainable and appropriate green finance flows, the various regulatory authorities (FCA, PRA, TPR, and FRC) should:

- Speed up the development and implementation of a robust, meaningful foundational taxonomy which: i. makes it clear which economic activities are climate supporting (green) and climate damaging (brown); and ii. allows for assessment of the contribution each part of the financial supply chain makes to the green transition. Effective financial stability, prudential, conduct of business, and financial reporting and disclosure regulation can only be built on a robust, trusted foundational taxonomy.
- Prescribe in detail how each layer of a financial instrument/ fund/ product aimed at end-users is to be assessed and rated (whether internally or by an external ratings agency) and then marketed and promoted. The layers include underlying constituents (securities/ assets/ funds), investment portfolios, and products/ funds aimed at end-users (retail investors, insurance policyholders, pension scheme members).
- Ensure that relevant fund governance bodies (or pension scheme trustees) oversee and report to end-users on the integrity of any assessment and ratings approach, and performance against goals. Financial market institutions (eg. investment banks) who do not deal directly with end-users should report to the relevant regulatory authorities.
- Supervise closely the practices of external ratings agencies. In an ideal world, assessment and ratings of each of the layers would be undertaken by a non-profit, public interest organisation. This would avoid the conflicts of interest inherent in the provision of ratings by commercial organisations. But, that is not going to happen, so it is important that commercial agencies are regulated very closely. We very much support the idea of bringing ratings agencies within FCA regulation. The FCA should be more prescriptive about the methodologies used by ratings agencies. The lack of standardisation and consistency in the provision of ratings undermines the ability of end users to make informed decisions.
- Supervise issuer, fund manager, product manufacturer/ provider compliance with regulations and rules at authorisation stage and on an ongoing basis, and use sanctions for non-compliance. If this happens, any third party verification is likely to be superfluous and may indeed add to the confusion. Of course, there would be nothing to stop independent civil society organisations undertaking their own investigations and research to expose misleading practices.

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[25] For more detail, please see here: Financial-Inclusion-Centre-submission-to-FCA-dp21-4-final.pdf (inclusioncentre.co.uk)

31. Are Scope 3 (supply chain) emissions data important for investors to assess and manage climate-related risks and opportunities?

Yes. It is important that regulators, the market (investors, insurers, and lenders etc), and retail financial consumers are able to recognise and assess the end-to-end contributions made by economic actors in financial and economic supply chains to climate damage.

32. Is there a role for the UK government to support businesses (of different types and sizes) to make good quality Scope 3 emissions disclosures (including SMEs in the value chain of disclosing entities)? If so, what should this be?

No comment.

LEADING INTERNATIONALLY

33. Up to 2030, how can the UK government best support the global transition to a net zero, nature-positive financial system that is both inclusive and resilient?

The sheer scale and influence of the UK's financial system and markets means the UK has a particular opportunity to play a positive role in supporting the ***global*** transition to a net zero financial system. Conversely, if UK policymakers take the wrong approach, the UK financial system and markets could have a significantly detrimental effect on those ambitions.

Therefore, the best way the UK government and financial regulators can support a sustainable, effective transition is to ensure the UK is a beacon of best market practice and financial stability. This means constructing the UK system according to the positive principles set out in the responses to Q1, Q26, Q28, and Q30, and avoiding the risk of a regulatory race to the bottom inherent in the government's plans to provide regulators with a 'competitiveness' objective.

Moreover, there is an opportunity for the UK to play a leadership role and exercise positive influence on international standards in policy setting and regulatory institutions such as the G7, G20, UN, IMF, and Bank for International Settlements, Network for Greening the Financial System, and the Financial Stability Board.

34. How can the UK government increase the mobilisation of public and private investment to achieve 2030 climate and nature targets in emerging and developing economies?

No comment.

35. How should the UK government assess and measure progress towards the transition of the global financial system and mobilisation of finance for global climate and nature goals?

The principles set out in Q26 and Q29 provide a framework for measuring progress of the UK financial system and markets. These principles can be adapted for measuring progress global climate goals and adopted by the appropriate international policy setting and regulatory institutions.

BUILDING ON THE GLASGOW LEADERS' DECLARATION ON FORESTS AND LAND USE

36. How can governments work with the financial sector to help align the global financial system with the Glasgow Leaders' Declaration goal of reversing forest loss and degradation by 2030?

No comment.

37. What support is needed to help firms to factor AFOLU related emissions and potential risks into their strategic planning?

No comment.

SUPPORTING AN INCLUSIVE TRANSITION IN EMERGING AND DEVELOPING ECONOMIES

38. What are the unique challenges for emerging and developing economies in meeting the requirements of the transition to a net zero and nature-positive global financial system, and how can the UK best provide support to overcome these?

No comment.

MOBILISING FINANCE IN EMERGING AND DEVELOPING ECONOMIES USING GREEN BONDS

39. Considering the key market incentives and barriers, how can the UK best support an increase in high quality, green bond issuances for emerging and developing economies?

No comment.

This marks the end of the submission by The Financial Inclusion Centre

June 2022