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FINANCING THE NET ZERO TRANSITION
WHY A UK STRATEGY IS NEEDED, AND WHAT SHOULD BE IN IT

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The UK's forthcoming Net Zero Strategy should set out a strategic approach to financing the UK's climate transition as part of a green economic recovery. This would send signals to financial markets about their role in supporting the achievement of decarbonisation and resilience goals in the real economy and unlock the huge potential available globally of net zero capital for the UK's transition. A proactive approach will also support levelling up by directing investment to the right projects, places, and people.

Key elements of a UK strategy to finance the transition should include:

1. A quantitative assessment of the UK's financial needs for the climate transition.
2. A mapping of existing tools and institutions, together with gap identification.
3. An action plan that makes use of the government's full toolbox - including public finance and economic management, institutional levers, financial standard-setting, private sector regulation, and a comprehensive diplomatic strategy.

Background

In recent years, the UK has announced a series of robust actions on green finance, building on the Green Finance Strategy released in 2019[1]. These actions include becoming the first major economy to implement mandatory TCFD by 2025, announcing the creation of a green taxonomy, updating the mandates of both the Bank of England and financial regulators to take the net zero transition into account, committing to issue green sovereign bonds with an associated green retail savings product, and launching a new National Infrastructure Bank. During the same period, climate has become a mainstream financial issue. Green investments are outperforming the market, and high-emissions investments look increasingly risky. Major financial firms around the world have been making net zero commitments, and shareholders are increasingly calling for companies to publish credible climate transition plans and to take action[2].

However, the size and urgency of the challenge to finance the net zero transition is substantial. The Climate Change Committee in its 6th Carbon Budget recommended that to get the UK to net zero, additional infrastructure investment from public and private sources will need to scale up from £10bn per year in 2020 to £50bn annually by 2030 and continue at that level through to 2050. The UK can also expect to see increasing costs associated with the physical impacts of climate change over this period. The UK's 2019 Green Finance Strategy does not include a needs assessment or an understanding of the co-benefits of the transition, nor does it outline a plan to meet the UK's needs.

Furthermore, the state of the UK economy has changed dramatically since 2019. The economic impacts of the pandemic have accelerated existing market trends and has given a much greater role to public finance as a guiding force for economic development. The UK is committed to 'Building Back Better' and to achieving a green economic recovery that also addresses social and economic inequalities by 'levelling up'. A proactive approach will be key to ensuring the benefits from the UK low-carbon transition are distributed across the whole of the UK, and investment flows are directed to the right projects, people, and places in a way that visibly delivers.

With one third of global assets under management now covered by net zero commitments[3], there is palpable appetite for the UK to become a global green finance hub. The UK has world leading climate targets, which should mean the City is a prime candidate to attract the over $32 Trillion of private assets committed to net zero. However, it is difficult for private investors to see the scale of UK opportunities without an overall plan.

A strategic and systematic plan will help private capital identify the investment opportunities of tomorrow and will drive capital towards the non-traditional infrastructure needed to drive a

[1] **https://www.gov.uk/government/publications/green-finance-strategy**

[2] Firms have been making commitments on an individual basis and through shared platforms such as the **Net Zero Asset Owners Alliance**, and the **Net Zero Asset Managers Alliance**. Shareholder pressure is being mobilised through platform initiatives such as **Climate Action 100+** and **Say on Climate**.

[3] **https://www.netzeroassetmanagers.org/net-zero-asset-managers-initiative-triples-in-assets-under-management-as-43-new-asset-managers-commit-to-net-zero-emissions-goal**

green industrial revolution and level up. Through employing a broad range of regulatory and financing signals, a Net Zero Financing Strategy will also create new markets and generate long-term returns in essential infrastructure such as green hydrogen, building retrofits, and nature. Together with regular transparent monitoring, this will support a fair, levelled up transition and generate continued public support.

The government should seize this unique opportunity to set out a strategic approach to financing its climate transition and ensuring the UK's green economic recovery, setting a leadership example to other major economies. The 2021 Net Zero Strategy is the obvious vehicle for setting out the UK's plan for financing the transition, incorporating a high-level strategic approach to be published before COP26. This could be followed by a more detailed National Financing Strategy in 2022, delivered as part of the planned review of the Green Finance Strategy.

Key elements of a strategic national approach to financing the transition

Creating a strategic approach to climate finance delivery will require the following elements:

> **Quantitative Needs Assessment**
> **Mapping of existing tools and institutions**
> **Comprehensive Action Plan**

Quantitative Needs Assessment

A strategic approach to financing the climate transition requires a quantitative assessment of the finance required. The upcoming Net Zero Review would be the landing point for this. Detailed analysis of the UK's investment needs across key sectors to 2050 has already been provided by the Climate Change Committee, both in its 6^{th} Carbon Budget and through the work of its Finance Advisory Group.

This should be complemented with an assessment of the co-benefits of climate action such as improved air quality, sustainable infrastructure, and the creation of good quality green jobs. Complementary analysis on the costs and distributional effects of the climate transition will soon be published by HM Treasury in its Net Zero Review. The interim version of this report concluded that "The costs of the transition to net zero are uncertain and depend on policy choices", making the launch of the UK's Net Zero Strategy an ideal moment to set a clear policy direction and narrow down the range of possible costs and co-benefits. Further steps will include establishing milestones.

Analysis conducted by LSE for the Aldersgate Group has suggested that transition costs will be lower overall if they are front-loaded, taking advantage of historically low interest rates to maximise the opportunities for investment in infrastructure[4]. The government has recognised the importance of front-loading infrastructure investment by creating a new National Infrastructure Bank with a net zero mandate. However, it is not clear that this institution is yet sufficiently capitalized, given the scale of need. A comprehensive needs assessment for the UK is now required in order to assess where there may still be gaps.

Mapping of existing tools and institutions

The UK has a mature financial ecosystem that was not designed to support the economic transition to net zero. It is now important to map the UK's existing financial institutions and architecture and to identify where changes may be required.

This change is already happening in a piecemeal way with some important results, including new mandates for the UK financial regulators, a new UK Infrastructure Bank, and the end of public export finance to fossil fuels. However, all these decisions were taken on a one-off basis in the absence of a full system mapping. To be sure of success in the future, a more strategic approach will be needed.

Comprehensive action plan

The range of actions available to the UK to finance the transition goes well beyond the direct provision of public finance to include a wide range of regulatory and enabling actions, as well as the creation or reform of public finance institutions and mechanisms. Used strategically and in combination, these tools can send the market signals needed to unlock private finance at scale. The principles below should guide the strategic design process of this plan.

Box 1: Design Principles for a National Financing Strategy[5].

1. **Inclusivity:** Create the enabling conditions across the financial system to support climate investment, including financial policies and regulation, investment and risk appraisal, portfolio management and appropriate mechanisms to support programme and project development.

2. **Equity:** Appropriate attention should be paid to the 'Who Pays' question of the transition, and equitable access to finance should be provided to actors across the market to facilitate transformational change.

3. **Predictability:** Securing resources from different sources to support long-term implementation and transition to a Low Emission and Climate Resilient economy, and providing certainty to market actors on the transition.

[4] '**Rebuilding to Last: How to design an inclusive, resilient and sustainable growth strategy after COVID-19'**, LSE/Aldersgate Group, 2020

[5] **Strategic national approaches to climate finance - E3G**

4. **Transparency:** Ensuring that the country has clear definitions and systems that allow for tracking and evaluating the financing flows in terms of the core principles above (sustainability, equity, and inclusivity).

Recommendations for Public, Private and International action within a Net Zero Financing Strategy

The recommendations in this briefing concern the element of the upcoming Net Zero Strategy that focus on finance. They build on recommendations made in a previous E3G briefing paper published in 2020, 'Economic Management and Climate Change: The Opportunity for the UK'[6].

Actions that the government can take forward as a public finance actor:

> **HM Treasury's upcoming Net Zero Review should present a quantitative assessment of the UK's climate investment needs or signal its intention to do so.** In the meantime, the scale of the overall challenge has been set out by the Climate Change Committee, with the 6th Carbon Budget recommending that to get the UK to net zero, additional infrastructure investment will need to scale up from £10bn per year in 2020 to £50bn annually by 2030, continuing at that level through to 2050. To develop scenarios for the Financing Pathway, either this data, or the Bank of England's scenarios, could be used[7]. This review could suggest the direction of travel for carbon tax and subsidy reform.

> **The Net Zero Review should also provide clarity on the distributional aspect of the transition.** The Government's stated objective is to support green jobs and green investment across many sectors and regions and 'places an even greater priority on the fair distribution of policy costs and benefits'. It is therefore important that an assessment of costs and benefits of the transition is undertaken to ensure that the transition is just, and that the benefits are shared throughout the UK.

> **The UK could also establish a National Net Zero and Resilience Office within the Cabinet Office** to consider the national net zero and resilience implications of all investment plans and decisions and ensure that appropriate steps are taken to address them. The Office should work closely with the Infrastructure and Projects Authority, as well as the National Infrastructure Commission and UK infrastructure Bank to ensure it has the latest in information and thinking. The Cabinet office should be responsible for coordinating the plan and holding departments to account on delivery[8].

> **The UK should implement a Net Zero Test for all government spending decisions** to ensure that they are in line with the UK's domestic and international targets on Net Zero and to support an integrated approach to tackling climate change.

[6] '**Economic Management and Climate Change: The Opportunity for the UK**', E3G, 2020

[7] Bank of England (2019). The 2021 biennial exploratory scenario on the financial risks from climate change.

[8] **Net zero: how government can meet its climate change target | The Institute for Government**

> **The Government should create an observatory tracking financial flows in real-time to quantify investment at the national and regional level and identify shortfalls in investment and barriers to levelling up.** This would complement the role of the National Infrastructure Commission but take a financial perspective and could potentially be performed by the UK Infrastructure Bank. This would help provide the credibility and trust, which will be key to the transition whilst highlighting investment opportunities for the private sector.

> **The National Infrastructure Bank should be viewed as the linchpin in the public delivery of financing for a broader net zero strategy[9].** It should work with the Government, the National Infrastructure Commission and the Infrastructure Projects Authority, and other funding bodies across Government, to divert capital to low carbon and nascent technologies across a range of sectors needed for the transition to net zero. The Bank's dual objectives of helping the Government fulfil its Net Zero target and levelling up should manifest as clear investment principles that enable green investment to be spread across the whole economy, including a variety of sectors, SMEs, pipelines, and geographies. HMG should commit to significantly increasing the bank's capitalisation over time in line with a robust national needs assessment[10].

> **The Green Gilts and Green Retail Savings Product should support the National Infrastructure Bank in delivering further green spending for decarbonisation.** The associated framework for these products is to be released in the Summer. The development of these frameworks should be harmonised with the green taxonomy and national infrastructure banks and should engage a range of stakeholder perspectives to provide guidance on what is and what is not eligible for green bond spending.

> **A complete end to UK public finance allocated to fossil fuel projects both domestically, and internationally, should be implemented imminently**. The announcement of a full stop to UK export finance for fossil fuels is welcomed, and the decision should be replicated domestically. The statement from BEIS on the North Sea transition deal[11] indicates a poor allocation of public finances, which puts the burden of the transition on the taxpayer and continues to subsidise fossil fuel production. Failure on this front will undermine the UK's credibility and influence in international climate leadership. The Bank could be used to help fund the transition and support investment in green, good quality jobs.

> **The UK's Whole of Government Accounts should be restructured to identify and designate green spending across sectors; this would allow the HMT to assess whether public finance is being deployed as required to deliver the UK's goals[12].** The WGA could also be adjusted to count adaptation as an investment instead of spending, as adaptation is known to provide indirect returns. As part of an overall process to align the WGA with the Paris Agreement, the UK's public sector's exposure

[9] https://www.common-wealth.co.uk/reports/public-finance-for-a-green-new-deal-why-we-need-to-change-the-rules#chapter-3

[10] UK Budget 2021: Chancellor Underpowers Green Industrial Revolution - E3G

[11] https://www.gov.uk/government/publications/north-sea-transition-deal

[12] http://www.oecd.org/environment/green-budgeting/paris-collaborative-expert-workshop-march-2020.htm

to climate-related financial risks could be evaluated and disclosed in line with the recommendations of the Taskforce for Climate-related Financial Disclosure, recently made mandatory by 2025 within the UK. The UK could also publicly set out an approach to dealing with contingent liabilities associated with climate risk within the UK's public accounts.

> **The UK should take practical steps to monitor and evaluate the effectiveness of public finance in the context of climate change through the following mechanisms:**

- A UK Green Balance Sheet to assess the UK's environmental assets and liabilities, which builds on existing tools, could be included in the Balance Sheet Review process[13].
- A Green Performance Report could assess the UK's green budget and balance sheet concerning the UK's stated targets. This could be included in the Annual Report and Resources account.
- Stress testing the UK's fiscal outlook to 2050 as part of the Managing Fiscal Risks report could help make the economy resilient to shocks.

> **The Office for Budget Responsibility should support HM Treasury to commit to testing its GDP growth forecasts against different plausible future climate change scenarios**. HMG should follow the Environment Agency in making use of a 4-degree scenario, which has already been proposed by the Climate Change Committee as the appropriate scenario to use when planning UK climate adaptation[14].

> **The UK should conduct regular stakeholder engagement** with finance actors, local authorities, and relevant market actors to ensure that a National Financing Strategy evolves as needs evolve.

Actions that the government can take forward as a regulator of private finance:

> **Implement the recommendations of the Climate Change Committee's Advisory group on Finance to create a net zero financial sector**[15]. There is an important role for regulators in setting a clear direction of travel for financial sector firms and setting an expectation that they will support the UK's net zero policy goal[16]. The CCC's recommendations include:

- Fully integrating climate risk and net zero into financial regulation and monetary policy (including assessing legacy rules for alignment).
- Making net zero targets and plans mandatory for financial institutions.
- Extending investor stewardship to incorporate the achievement of net zero.

[13] https://blog-pfm.imf.org/pfmblog/2019/06/reviewing-the-uk-balance-sheet-proving-its-net-worth.html

[14] https://www.theccc.org.uk/wp-content/uploads/2019/07/CCC-2019-Progress-in-preparing-for-climate-change.pdf

[15] **https://www.theccc.org.uk/publication/the-road-to-net-zero-finance-sixth-carbon-budget-advisory-group/**

[16] **National Climate Finance Strategies - Mobilising the private sector for scaled-up investment - E3G**

- Setting clear metrics for the net zero transition at the institutional and product levels.

> **Fight greenwash and provide the private sector with sufficient guidance and clarity on what 'good looks like' in terms of credible net zero commitments and transition plans from private finance.** Potential policies and regulation to support net zero private finance include:

- **Successfully implementing TCFD by 2025 and ensuring sufficient guidance and support on disclosure is provided to private actors across the variety of industries.**

- **Require UK-regulated financial firms to publish their plans for Paris alignment by 2021 and set clear expectations for robust methodologies.** As outlined by Mark Carney[17] in his role as Prime Minister's Finance Adviser for COP26, financial and actual economy firms will increasingly be expected to develop and disclose their transition plans as recommended by the TCFD. The UK can take a leadership role by making this a requirement for the financial sector. Transition plans are increasingly part of conservative political discourse as suggested by a recent paper from Policy Exchange[18].

- **Fighting greenwash by setting standards and guidance on 'what good looks like' to ensure that private finance implements high-quality transition plans** that are credible, sufficiently ambitious, and consistent with the 1.5C Paris Agreement aligned temperature goal. This standard setting can build on existing work by initiatives like the Net Zero Asset Owners Alliance and UNPRI, and it could be supported through mechanisms like the Glasgow Financial Alliance for Net Zero[19].

- Supporting shareholder appraisal of credible net zero targets and transition plans as part of firms' fiduciary duty to their shareholders. This could involve **supporting the Say on Climate initiative[20] and establishing shareholder voting on Transition Plans.** Through this, shareholders are empowered to take a more active role in evaluating company transition plans.

- **Transparency from HMG on its criteria for net zero** (including use of offsets, removals, and carbon credits), **building on the upcoming classification opportunities** such as the UK Infrastructure Bank Investment Framework which will be released in Spring, and the Green Taxonomy, Green Bond Framework and Green Retail Savings product frameworks to be released in Summer 2021.

> **The UK should ensure that the embedding of climate considerations across public regulatory bodies such as the Prudential Regulation Committee (PRC) and the Financial Conduct Authority is comprehensive and meaningful**, following the updates to the remits of the Bank of England's Monetary Policy Committee and Financial Policy Committee as updated by the Chancellor at the Budget 2021. A letter from the Chancellor to the FCA and PRC has now taken similar steps and mandated that these agencies should now account for the Government's legally binding

[17] https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/the-road-to-glasgow-speech-by-mark-carney.pdf?la=en&hash=DCA8689207770DCBBB179CBADBE3296F7982FDF5

[18] https://policyexchange.org.uk/publication/capital-shift/

[19] https://unfccc.int/news/new-financial-alliance-for-net-zero-emissions-launches

[20] https://www.sayonclimate.org/

commitment to transition to a net zero economy by 2050[21]. The UK could ensure the integration of climate into the capital requirements framework, taking inspiration from the work being carried out by European Supervisory Agencies.

> **The new UK Green Taxonomy should be used to provide guidance on green investments to private finance**, providing clarity on which investments are compatible with the UK's net zero and resilience target and certainty to the market. This consistency will facilitate the crowding in of private finance to future-fit investments.

> **The UK should ensure that the outcomes from the design of the National Infrastructure Bank Investment Framework, the Green Taxonomy and the new Green Sovereign Bond and Green Retail Savings products are harmonised** and send clear signals to the market as to what is green, and what is not. The Green Taxonomy should work with and coordinate with the EU Taxonomy to ensure that market actors are sent the same signals for investment both domestically and internationally. On the latter two products, these funds can be used to support green recovery spending in the UK, with the Green Bonds issuance in 2021-22 expected to raise over £15 billion.

Actions that the government can take forward for international leadership:

Actions on finance taken by the UK alone cannot be effective unless progress is also made to set new international financial norms. International leadership will be necessary to create the broader market signals that will drive private sector investment decisions, and the UK should develop a comprehensive diplomatic approach to financing the transition.

> The UK's G7 Presidency, with the G20, could establish a **Joint Taskforce on Mobilizing Investment at Scale for National Climate Goals**. It should formulate, by 2022, design recommendations for a global platform to connect and expand architecture for mobilizing finance toward national climate plans. The Taskforce should include senior officials, and public and private finance institutions from G20 and non-G20 countries, as well as international financial institutions. It should also work with the Task Force on Access to Finance, established by the Climate and Development Ministerial, to tackling the barriers that exist to accessing the finance needed to support the delivery of climate action and sustainable development[22].

> **The UK should promote national investment plans, and capital mobilisation strategies for mitigation and adaptation actions that support NDCs and are aligned with Long Term Strategies**[23]. Financial plans based on long-term thinking can significantly enhance the quality of the global stock of NDCs in this revision cycle, particularly if better tied to national planning and other macroeconomic policies[24].

> **The UK needs to work with other nations to establish international science-based norms on defining green**, utilising the opportunities of platforms such as the UK's

[21] Climate considerations now fully embedded across UK principal financial regulators - GOV.UK (www.gov.uk)

[22] https://ukcop26.org/climate-development-ministerial-chairs-summary/

[23] Public Finance for a Green New Deal: Why We Need to Change the Rules (common-wealth.co.uk)

[24] https://www.e3g.org/publications/better-recovery-opportunities-for-transformative-action/

membership of the International Platform on Sustainable Finance (IPSF) and the impact this may have on the development of a global taxonomy standard.

> The G7/G20 Communiques could announce **a Leaders' and FMCBG process to mobilize public and private investment at scale toward national climate goals**. It should acknowledge the essential role of public finance in this effort while noting the opportunity to harness large-scale climate-related private investment. In the frame of green recovery and sustainable development, it could have an emphasis on developing countries.

> **The UK, as G7 and COP26 President, could create an overarching diplomatic strategy for securing systemic financial reforms in 2021.** This could involve working within the G20 Green Finance Study Group to link the work of the International Sustainable Finance Platform, the Network of Greening the Financial System, and the Coalition of Finance Ministers, creating a connective tissue for economic management reform to be cascaded to national level.

> **As a shareholder of the IMF, the UK should play a role in keeping the momentum by influencing its Board to support the IMF Director's proposals for a green recovery** and mandating the IMF to provide technical support for the long-term decarbonisation plans. This could also incorporate reassessments of countries' fiscal space and a further allocation of Special Drawing Rights to support green investments – both established proposals that require support to be taken forward. Moreover, the UK could support calls from a recent Net Zero Finance report for the IMF to integrate Net Zero into its mandate[25].

> **The UK should reverse recent cuts to Overseas Development Aid before COP26 to ensure that the UK maintains its position as an international leader in financing climate transition**. ODA financing should be seen as part of a broader package of measures to protect the UK's interests overseas and fulfil its domestic and international climate and resilience commitments.

Conclusion

Through the Net Zero Strategy, the UK has a window of opportunity to set out a strategic approach that would provide the signals, direction, and capital necessary for mobilisation of financial flows at scale to meet UK policy goals. The appetite is there at scale from the private sector for a well-regulated global green finance hub – that the City of London is primed to meet.

The government should seize this moment and build a foundation now that will enable a better recovery, and a future economy that is fair, prosperous, and resilient.

About E3G

E3G is an independent climate change think tank accelerating the transition to a climate-safe world. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes chosen for

[25] **https://www.lse.ac.uk/granthaminstitute/publication/net-zero-central-banking-a-new-phase-in-greening-the-financial-system/**

their capacity to leverage change. E3G works closely with like-minded partners in Government, politics, business, civil society, science, the media, public interest foundations and elsewhere. More information is available at **www.e3g.org**