Response to the Chancellor on ambition for future of UK financial services

Dear Chancellor,

We welcome your ambition to position the UK at the forefront of green finance. Faced with a dual emergency of the coronavirus pandemic and the climate crisis, the financial sector has a crucial role to play in supporting a resilient and sustainable recovery. A year ahead of hosting the world's leaders in Glasgow for the COP26 conference, your government has an unprecedented opportunity to shape the global green finance agenda.

Your recent announcement outlining plans to make TCFD aligned disclosures mandatory across a large part of the UK economy, as well as the Bank of England's confirmation that it will conduct the postponed climate stress test in June 2021, are therefore welcome.

However, these policies must be considered as just the first steps towards greening Britain's financial system. They will not be sufficient in themselves to align financial flows with the government's climate targets. We need bolder policies that reshape finance and harness its potential to help build back better by supporting a green recovery and the government's leveling up agenda.

Disclosures and climate stress testing are commendable strategies to green the financial system. However, they are based on two flawed assumptions. First, they assume that markets are efficient and financial institutions can effectively self-regulate. The 2008 global financial crisis served as a wake-up call to the reality that financial markets left to their own devices are prone to excessive risk-taking and unable to price assets efficiently. In recognition of this trend, central banks including the Bank of England have been given expanded macroprudential roles in order to proactively mitigate against systemic risks.

Second, the effectiveness of disclosures and climate stress testing also relies on the idea that climate risks are quantifiable. However, this has been challenged by green finance experts. In a recent report, the Bank of International Settlements demonstrates that the 'radical uncertainty' associated with climate change impedes precise quantification of the risk it presents.[1] Substantial 'unknown unknowns' mean that financial markets may not be able to accurately 'price in' climate risks.[2] Relying solely on market-led approaches therefore risks both failing to manage material risks to the financial system, and failing to sufficiently 'green' finance flows within the timeframes remaining for transformative action.

The set-up of the current financial system is not geared towards providing the vital patient strategic finance needed to support jobs, businesses and local communities in line with a green recovery. Prior to the crisis, a significant share of bank credit was directed towards property and real estate (55%) and the financial sector (26%) with very little lending (8.5%) for non-financial businesses. Of the business loans, only 2-3% of all bank lending was for

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[1] Bolton, P., Després, M., Pereira da Silva, L., Samama, F. and Svartzman, R. 2020. *The green swan: Central banking and financial stability in the age of climate change* [Online]. Bank for International Settlements. Available from: https://www.bis.org/publ/othp31.pdf.

[2] Chenet, H., Ryan-Collins, J. and van Lerven, F. 2019. *Climate-related financial policy in a world of radical uncertainty: Towards a precautionary approach* [Online]. UCL Institute for Innovation and Public Purpose. Available from: https://www.ucl.ac.uk/bartlett/public-purpose/wp2019-13.

SMEs that form the backbone of our economy – 99.9% of UK businesses are SMEs, 60% of private sector jobs come from SMEs, while 40% of GDP is derived from SMEs.[3]

According to the Bank of England, the City of London is complicit in setting us on the path for more than 3.5 degrees of warming above pre-industrial levels by 2100.[4] Indeed, the Bank's own corporate bond portfolio is currently aligned with this 3.5 degrees pathway, which is materially well above the Paris Agreement goals.[5] This mismatch between rhetoric and action on the part of the Bank is not only undermining the UK government's climate targets, but also the high risk standards to which it is supposed to hold private financial institutions to account.

Instead of being led by markets, the Treasury and the Bank need to take a proactive approach. The policy decisions of the coming weeks and months will define the course of the crucial decade ahead. By acting swiftly and decisively, the Treasury - supported by the Bank - can help to deliver two of the UK government's key ambitions: a green recovery from the Coronavirus crisis and a ground-breaking COP26 summit where the UK leads in showing how finance can be reshaped to deliver net zero.

For this to happen the Treasury needs to equip the Bank of England with an updated mandate that clearly outlines its role in supporting the green recovery and combating the climate emergency. This would empower the Bank to adjust existing programmes in order to better support jobs, the green transition and future financial stability. To start with, these adjustments should include the following:

First, the Bank should encourage private financial flows towards green, job-creating projects to support the economic recovery and the net zero transition. This can be achieved by including climate-related criteria in the Term Funding Scheme to provide cheaper funding for sustainable investments.

Second, the Bank should integrate climate-related financial risks into its collateral framework and asset purchases. This will help better reflect climate financial risks in the allocation of financial flows and the price of capital in financial markets more widely. Governor Andrew Bailey has already said this is 'perfectly sensible', but since March the Bank has been waiting for the Treasury to adjust its mandate accordingly.

Third, the Treasury should permit the Bank to help capitalise a new Green Investment Bank (GIB) to support lending to sustainable projects. It could reinvest the maturing proceeds of the Covid Corporate Financing Facility (CCFF) into a GIB, which would not increase the net debt burden of the government. Similar actions were taken by President

[3] See Bank of England 2020.Bankstats Tables [Online]. Available from, https://www.bankofengland.co.uk/statistics/tables
[4]Carney, M. (2019). Treasury Select Committee Hearing on the Bank of England Financial Stability Report [Online]. Available at: https://www.bankofengland.co.uk/events/2019/october/tsc-hearing-on-the-financial-stability-report
[5] Bank of England 2020. The Bank of England's climate-related financial disclosure 2020 [Online]. Bank of England. Available from: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/climate-related-financial-disclosure-2019-20

Roosevelt to support the New Deal in the 1930s[6], and by the Bank of England itself, who supported the creation of the Industrial and Commercial Finance Corporation and Finance Corporate for Industry after the Second World War.[7]

Finally, the establishment of a green taxonomy will help realise these endeavours, and we therefore commend your commitment to implement one. But limiting the taxonomy to green activities will not necessarily encourage a move away from financing activities that undermine climate goals. We equally need the taxonomy to classify carbon-intensive and other unsustainable activities. Importantly, the taxonomy design should not be decided behind closed doors. There must be transparency and public consultation to ensure that a wide range of expertise and perspectives from across civil society and academia feed into the UK's Green Technical Advisory Group.

With one year to go until the COP26 in Glasgow, the UK has a real opportunity to lead the world in facing the existential threats of climate and environmental breakdown. You can count on our support in delivering this transformative agenda, and we look forward to your next steps.

Yours sincerely,

The undersigned

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[6] Ryan-Collins, J., & Van Lerven, F. (2018). Bringing the helicopter to ground: a historical review of fiscal-monetary coordination to support economic growth in the 20th century. *UCL Institute for Innovation and Public Purpose Working Paper Series (IIPP WP 2018-08)*.
[7] Capie, F. (2010). *The Bank of England: 1950s to 1979*. Cambridge University Press.

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