A National Wealth Fund for a just green transition

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Summary

Despite the UK financial sector holding trillions of pounds worth of assets, the real economy has suffered chronic underinvestment, particularly in the infrastructure projects required for a just green transition.

A range of interrelated factors have limited private finance's ability to invest in such projects, such as short-term investment horizons, liquidity preferences, risk appetite, uncertainty over returns, as well as coordination and collective action problems. Public financial institutions have a critical role to play in overcoming these barriers, leveraging the state's unique advantages in terms of scale, risk-tolerance and longer-term investment horizons.

Existing public financial institutions like UKIB and BBB have had limited impact in mobilising capital because they have not been empowered to act as true public investment banks that are able to issue their own liabilities and leverage their balance sheet like Germany's successful KfW. Rather they have acted as funds, only able to deploy a relatively small amount of capital allocated by the government.

A new National Wealth Fund, which would align UKIB and BBB under its umbrella, offers an opportunity to build an enhanced public banking ecosystem to coordinate public and private investment. If empowered to issue its own liabilities, the NWF would be able to meet private finance's demand for productive safe assets, while crowding-in a much larger quantity of capital towards the real economy and a just green transition.

Recommendations

- The government should embrace the opportunity presented by a NWF to review, consolidate and strengthen the UK's fragmented ecosystem of public financial institutions.
- The government should empower the NWF to issue its own liabilities across a range of maturities, to meet private finance's demand for safe assets that support the real economy and the green transition.
- The additional £7.3bn of funding announced by the government should take the form of equity capital, which could allow the NWF to mobilise more than £180bn, or around £228bn if UKIB and BBB's balance sheets are consolidated under a NWF.
- Over time, the NWF should target an 8% leverage ratio, which would allow it to mobilise £250bn over ten years with £20bn of equity, or to £460bn (the same per-capita size of Germany's KfW) with £40bn of equity.
- Liabilities issued by the NWF should be excluded from measures targeted by fiscal rules, including public sector net debt (PSND).
- The NWF should be equipped with an investment mandate and objectives that prioritise supporting the government's industrial strategy and economic missions, including a just green transition.
- The NWF's governance structures, such as boards, committees and informal advisory mechanisms, must include strong representation from trade unions and wider civil society, as well as industry.
- While funding should be centralised, a NWF should have structures enabling investment decisions to be decentralised, such as a network of regional banks.

Background

The UK has a small and fragmented ecosystem of public financial institutions, comprising the UK Infrastructure Bank (UKIB) and the British Business Bank (BBB). Despite the names, these institutions have not acted as true public investment banks like Germany's KfW, as they have not been empowered to leverage their balance sheets by issuing their own liabilities. Rather, they function like funds, only able to deploy a fixed amount of money allocated from the government.

Shortly after taking office, the new Labour government announced plans to align UKIB and BBB under a new National Wealth Fund (NWF),[1] with a National Wealth Fund Bill included in the King's Speech.[2] The government says the NWF "will simplify the UK's fragmented landscape of support for business and investors" and "will play a central role in the Government's industrial strategy and growth and clean energy superpower missions making transformative investments across every part of the country supporting thousands of good jobs and making everyone better off, while generating a return for the taxpayer."

This announcement came alongside the release of a report from the National Wealth Fund Taskforce Labour had commissioned while in opposition, which made a number of recommendations regarding NWF design and next steps.[3]

[1] Boost for new National Wealth Fund to unlock private investment - GOV.UK
[2] 17/07/24 King's Speech 2024 background briefing final GOV.uk.docx
[3] National Wealth Fund Taskforce

As an umbrella institution for a reinvigorated public finance ecosystem, the NWF could channel investment towards sectors and collective goods that are otherwise neglected by private finance. These may include both physical and social infrastructure projects, such as a decarbonised energy grid, clean water, nature and biodiversity stewardship, public transport, social housing, education and care, as well as investment in industries and SMEs to support a just green transition.

Box 01: How could a NWF best invest to support a just green transition?

Direct investment – Leveraging the state's ability to borrow at low rates, a NWF could minimise the cost of capital for infrastructure and industrial decarbonisation by investing directly in projects and companies, with debt instruments or equity stakes. Equity stakes would be a particularly optimal tool, as they would not only place less pressure on beneficiaries than interest-bearing debt, and they would also allow rewards to be better captured by the public, alongside the risks.

Lending to other public institutions – If GB Energy is also empowered to issue its own liabilities, a NWF could provide it with additional funding to invest in clean energy. This would reduce the cost of up-front capital investment, which renewable energy is particularly sensitive to, and thereby lower bills for consumers. Like Norway's Kommunalbank, a NWF could also be a key source of investment for local and regional authorities. Devolved administrations and councils could borrow cheaply from the NWF to invest in local just transition plans and increase the stock of social homes, building on UKIB's existing offer to local authorities.

On-lending to smaller banks – a NWF could also simply 'on-lend' funds to other financial institutions, which could use these funds to support loans to their customers. However to date on-lending has had limited success in the UK, as illustrated by the shortcomings of the BBB, as well as Bank of England refinancing schemes such as Funding for Lending and the Term Funding Scheme. This is because such schemes are reliant on a small number of large banks, whose business models are not geared toward building and maintaining relationships with communities and the real economy. To address this dynamic a NWF should prioritise on-lending to a diverse range of banking models, such as mutuals and other 'stakeholder' banks with regional and relationship banking focuses, as KfW does through Sparkassen in Germany.

Designing a NWF for a just green transition

Funding

UKIB was initially equipped with a financial capacity of £22bn, with access to £5bn of equity capital from HM Treasury and £7bn of debt capital, alongside £10bn of guarantees.[4] These funds are equivalent to only a fraction of the government's £700–755bn infrastructure pipeline for the next 10 years,[5] and the level of capital deployed by UKIB has been just 20% of that previously provided by the European Investment Bank. It is therefore welcome that the announcement of a National Wealth Fund included £7.3bn of additional capital to be allocated through UKIB. However the funding announced so far would be vastly insufficient if the NWF is expected to address the scale of investment needed for a just green transition, or even to play an equivalent role to public financial institutions abroad. The NWF's balance sheet would need to grow to more than £460bn to reach the same per-capita scale as the £580bn size of Germany's KfW.

The success of public financial institutions like KfW has resulted from it being able to leverage its own balance sheet by issuing its own debt, allowing it to mobilise significant investment even while the central government pursues tight fiscal rules. **The government should therefore empower a NWF to issue its own government-guaranteed debt across a range of maturities, to meet private finance's demand for safe assets that support the real economy and the green transition.**

Based on UKIB's initial £5bn of equity, the NWF could raise more than £73.5bn with a leverage ratio (debt-to-equity ratio) of 6.8% (equivalent to KfW's). If the additional £7.3bn of funding for the NWF announced by the government takes the form of equity capital, this would allow the NWF to mobilise more than £180bn with the same leverage ratio. Consolidating both UKIB and BBB's balance sheets under the NWF umbrella could mean additional equity capital of nearly £3.2bn, bringing the total up to as much as £15.5bn, which could be leveraged to mobilise around £228bn of investment with the same ratio.

Though the above figures are significant, they will likely be insufficient to close the UK's investment gap over the long-term. Reaching net zero alone will require £50bn of additional investment a year until 2050, according to the Climate Change Committee,[6] while new investment of around £10bn a year may also be needed to adapt to the effects of climate change.[7] Meanwhile, it has been estimated that SMEs face an investment shortfall of more than £20bn a year.[8]

The government should therefore scale up the NWF's ability to deliver on its missions with additional capitalisation over time. For instance, targeting a conservative 8% leverage ratio, the NWF could build up a £250bn balance sheet over 10 years with £20bn of equity. This would allow it to mobilise funds equivalent to a third of the UK's infrastructure pipeline over the same period. To reach the same per-capita scale as KfW, the NWF's balance sheet would need to grow to £460bn, which would require £40bn of capital to maintain an 8% leverage ratio, or £31.2bn with KfW's 6.8% ratio.

[4] https://www.ukib.org.uk/sites/default/files/2023-10/UKIB-Annual-Report-and-Accounts-2022-23_0.pdf
[5] National Infrastructure and Construction Pipeline 2023 - GOV.UK
[6] Sixth Carbon Budget - Climate Change Committee
[7] Investment for a well-adapted UK January 2023
[8] Improving access to finance for small and medium-sized enterprises - NAO report

Beyond increasing the NWF's scale, allowing the NWF to issue its own liabilities, rather than having to attract investment on a deal-by-deal basis, would have other key benefits:

Enabling pension funds and other institutional investors to invest productively

Many pension funds and other institutional investors do not have the capacity or appetite to conduct in-house due diligence of investments on a deal basis, and would instead prefer to invest at a fund level. Critically, liabilities issued by a NWF would provide investors with a new class of high-quality liquid assets, satisfying a high liquidity preference that increasingly constrains their ability to invest productively. This would enable the vast funds held by non-bank financial institutions to be shifted from unproductive and speculative assets towards supporting a just green transition.

As the Bank of England moves towards a repo-based approach to meet demand for reserves,[9] there will likely be increased demand for assets the central bank deems eligible as collateral. As high-quality liquid assets, liabilities issued by the NWF would be appropriate collateral for expanded central bank lending operations.

Supporting a just green transition

Raising funds on a project-by-project basis could also raise tensions between the goals of attracting private investment and the mission of supporting a successful industrial strategy and a just transition. The NWF may find itself having to prioritise maximising returns over social and environmental goals, in order to convince investors that individual projects will be investible.

Enabling the NWF to instead attract funds by issuing its own liabilities would allow it to cultivate a diverse portfolio of assets balancing risks and returns, with higher-revenue projects being able to offset investments in collective goods that may be harder to monetise. The issuance of bonds would provide investors with a reliable and fair return while allowing the NWF to use funds to pursue a just green transition without being forced to unduly prioritise revenue maximisation and the short-term demands of investors.

Relationship with fiscal rules

The Taskforce's report suggests that if the NWF is to crowd-in fund level capital (as argued for above), this would require further review of implications on fiscal rules, particularly the use of Public Sector Net Debt (PSND). The Taskforce proposes such a review could "consider the exclusion of certain public development institutions from PSND calculus through necessary governance reforms, changing the treatment of assets, or at least reducing emphasis on PSND in the fiscal rules."

Excluding public financial institutions like the NWF from fiscal rules would bring the UK in line with other European countries, allowing it to make prudent investments in the long-term capital development of the UK economy without interfering with debates on the government's day-to-day spending decisions. **Liabilities issued by the NWF should therefore be excluded from measures targeted by fiscal rules, such as PSND.**

[9] Let's get ready to repo! by Victoria Saporta - Speech - Bank of England

Mandate and objectives

The Taskforce's report recommends that the NWF is operationally independent from government, but has strategic alignment via a clear mandate and complementary economic policy. Arms-length operational independence from government would have the key advantage of making it easier for liabilities issued by the NWF to be excluded from fiscal rules, as argued for above.

If a NWF is to be operationally independent, getting its mandate and objectives right is of paramount importance. A NWF's key advantage lies in its ability to support the government's industrial strategy and economic missions, including a just transition, and this should therefore be central to any investment mandate and objectives. The government should also prioritise such goals in the key performance indicators (KPIs) it agrees for the NWF. Such KPIs could relate to the government's manifesto commitments, such as the creation of 650,000 quality jobs across the country by 2030, as well as metrics regarding regional investment and decarbonisation.

It is important that KPIs include both qualitative and quantitative elements to mitigate the risks of targets producing unintended outcomes. For instance, if the NWF has KPIs targeting a mobilisation rate for private capital or a quantity of overall investment, this could lead to the NWF pursuing investments that are 'easier' rather than those that are most impactful, in the absence of additional qualitative goals.

Governance structures

The Taskforce's report recommends that the NWF operates at arms-length from government, and that its governance should comprise of an independent Board and independent investment committee. The Taskforce also suggests the establishment of an informal governance/advisory mechanism to capture wider perspectives.

A NWF should focus on delivering for workers and communities, not just investors. As well as industry, the NWF's governing bodies must include strong representation from civil society, and in particular, trade unions, to help ensure the NWF supports a genuinely just green transition and shared prosperity.

A decentralised structure that devolves power

If a NWF is to act as a genuine national investment bank, issuing liabilities to mobilise large sums of private capital, it will need to have structures that decentralise investment decisions to ensure funds are best channeled to where they are needed across the whole country. These could take the form of a network of regional banks, through which the NWF could allocate funds to, and could build strong relationships with regional and local authorities, as well as local industry and SMEs in particular.[10]

Like the NWF itself, regional banks should be governed by boards with a diverse set of stakeholders, including representatives from regional and local authorities, trade unions and wider civil society, as well as industry. A network of 12 regional branches could be appropriate, with one each based in Scotland, Wales, Northern Ireland, as well as the nine regions of England.

[10] Such a model would resemble the solution Andy Haldane put forward when he was Bank of England chief economist to close the UK's investment gaps, of a "UK Development Bank, operating on a decentralised basis", which would create the scale and scope "necessary to reach SME start-ups and scale-ups across all sectors and all regions"

Conclusion

With a new National Wealth Fund, the government has a profound opportunity to reverse a chronic investment drought and mobilise tens of billions of pounds towards missions to rebuild Britain as a clean energy superpower. To realise this potential and enable the NWF to deliver for the whole country, policymakers must ensure it is equipped with the appropriate mandate, governance structures and borrowing powers.

If the additional £7.3bn funding announced for the NWF takes the form of equity capital, it could raise £180bn with the same leverage ratio as Germany's KfW. Taking a longer view, with a more conservative 8% leverage ratio, the government could mobilise £250bn over 10 years with £20bn of equity capital, or with £40bn of equity capital the NWF could grow to £460bn, putting it on the scale of KfW per capita.

Though funding should be centralised, investment decisions should be devolved through a decentralised structure, with strong representation from trade unions and wider civil society, as well as industry. Guiding the National Wealth Fund should be a mandate, objectives and KPIs which put industrial strategy and a just green transition front and centre.

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