# Financial markets in delivering net zero

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## EXECUTIVE SUMMARY

- Financial markets can be a positive force in delivering net zero by delivering the 'greening' of companies.
- This will require provision of information about the impact of companies' activities on the environment. This information will need to be properly audited to ensure general acceptance and should become a regular part of the auditing process.
- The tax authorities should encourage the provision and use of such information by using it to identify how green a company is and adjust tax allowances accordingly.
- Banks will need to develop information on the green activities of their borrowers and adjust interest rates to reflect the associated risks. This will incentivise SMEs to become greener.
- The major changes required to move towards a green finance model will imply significant volatility in market valuations. This will have unintended consequences for investors, funds, pension providers. Green finance policy will only succeed if it faces up to the challenges and does not ignore such unintended consequences.

## Background

The target of achieving net zero moved forward at COP26 but there are still many difficult issues to confront and changes to be made. Positively, there has been the increasing recognition that financial markets are important to achieving the goal. One aspect of this has been led by Mark Carney and the Glasgow Financial Alliance for Net Zero (GFANZ) and the UK Government set out a paper recently (Greening Finance: A Roadmap to Sustainable Investing) that emphasised the importance of companies providing information about how they were directly contributing (positively or negatively) towards the net zero target.

Recent research has emphasised the important role that financial markets can play in achieving net zero that builds upon the Environmental and Social Governance (ESG) concerns, upon which financial markets have increasingly focussed. The development of Green Investment Funds whilst gathering pace is still a very small part of the total amount of investment in financial markets each year. The pledge of the GFANZ to provide $130tn is impressive but still represents a small fraction of what will be required to achieve net zero.

Financial markets price risk but they do not price climate risk directly, only its consequences for their investment. The risk associated with climate change is often not linked specifically to the activities of those that create it. For financial markets and their users to understand better climate change risks requires the provision of high quality information and auditing of it to ensure its reliability. The Treasury report on Greening Finance provides a start but a much clearer statement of the institutional structures required to deliver on the Roadmap needs to be worked through.

## Key issues

**There should be recognition of the impact of investor preferences on financial markets outcomes. This will support the many investors who wish to contribute to the achievement of net zero**

The role of investor concerns about climate change has been found to contribute to the pattern of investment and the returns offered by green finance. Essentially polluting (as opposed to green) companies are viewed in the same way as the so-called 'sin stocks' (such as gambling, alcohol companies) and markets price them such that their cost of capital is higher.

Policy should be directed towards rewarding investors for choosing to take the net zero challenge into account in their decision.

**Stopping 'greenwashing'**

Once a 'greenium' exists then private companies will have an incentive to present themselves as green to benefit from the lower cost of capital. There needs to be proper reporting in place to assure investors that they are indeed making green investments. It will be important to ensure that the reporting requirements keep up with the attempts to nullify the regulations so that private companies do not enjoy the benefits of green finance without the costs.

Policy, that has been signalled in the Treasury report (see above), should focus on developing auditing systems to deliver widely-accepted standards of reporting on green activities that are not open to manipulation and fraudulent claims.

**Integrating green finance with the tax system**

We can enhance the tax system to deliver incentives for firms and their investors to switch to greener activities. A vital aspect of any tax system is that the taxable items are reported in a transparent and accurate way. With the reporting systems in place (as discussed above) the information that the tax system requires is ready so that it can be made more compatible with greening the economy.

Tax policy should be directed towards giving incentives to private investors and companies to adopt green strategies that contribute to the achievement of net zero.

**Small and medium-sized enterprises and the green economy**

For SMEs, who tend to access finance through banks, the loan decision-making needs to incorporate the impact on achieving net zero. The development of green-rating agencies to support banks in their pricing and terms of loans, much as we have credit rating agencies, could assist in this process. The British Chambers of Commerce reported that only 10% of SMEs are able to measure their carbon emissions and so this task will be challenging but crucial.

Regulation of banks should include the contribution that they make to achieving net zero. For example, capital requirements could be adjusted to reflect that banks' long-run risks include the impact of their lending on climate change. SMEs should be made aware that they will need to develop their business models taking the net zero pledge into account.

**Avoiding unintended consequences**

Inevitably the process of greening finance will create costs, since such a major change in the structure of production and consumption will require substantial resources even if spread over a relatively long period of time. For example the shift to electric vehicles from fossil fuel powered ones will imply a significant loss of tax revenue for the Treasury. The market capitalisation of the 10 largest energy companies globally was about US$2.2tr. Moves to green economic structures will impact on these companies very significantly. The market value of energy companies listed in the S&P500 fell 12% from January 2020 to January 2021. Poorer members of society will be hardest hit by the increase in costs that will come as a result of the move to net zero.

Policy-makers will need to consider these unintended consequences. Any policy that is introduced to achieve net zero should have an element that identifies the potential for unintended consequences and for the costs of these to be estimated.

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