THE GREEN NEW DEAL GROUP

How to pay for a Green New Deal: Harnessing private finance

The UK needs a major programme of investment in order to move our economy beyond fossil fuels, improve our public services and tackle the cost-of-living crisis. This is one of five briefings summarising how that investment can be paid for. To read the other briefings, visit greennewdealgroup.org.

Year after year, credit continues to pour into the fossil fuel industry, putting us all at risk. Since 2015, HSBC has provided over £62bn in financing to fossil fuels and industrial agriculture, while Barclays has provided more than £32bn. Despite widespread warnings that the world cannot sustain any new fossil fuel projects, UK pension funds also continue to invest in fossil fuels to the tune of around £88 billion. Financial institutions have significantly underestimated the riskiness of fossil fuel investments. Continuing to pour money into coal, oil and gas is certain to result in massive losses in the longer term – either because projects are abandoned as the green transition requires, leaving the assets 'stranded', or through global temperature rises of several degrees devastating the global economy. Efforts by central banks in recent years to better acknowledge climate risk have tended to focus on encouraging commercial banks to identify and disclose their exposure to risk, rather than any firmer regulatory measures.

More stringent measures by central banks are needed to disincentivise fossil fuel investments and encourage investors to put their money into green projects instead.

1. Increase capital requirements for fossil fuel projects

Capital requirements are a form of regulation requiring banks to hold a minimum amount of financial resource (capital) in relation to the loans they make. The amount depends on the riskiness of the loan. Holding capital comes at a cost to banks, meaning higher capital requirements for certain types of loan can discourage the provision of those loans.

The international One for One campaign calls for a 'one-for-one rule' for fossil fuel investments – the highest possible risk weighting, meaning for every £1 invested, financial institutions would need to hold £1 of capital to cover future losses, protecting the public from the cost of a massive bailout. The effect of this would be to deter future investments in fossil fuels and encourage the redirection of lending elsewhere.

2. Exclude fossil assets from the Bank of England's collateral framework.

Central banks set what is called a collateral framework, setting out what types of assets they will accept, and on what terms, to secure their lending to commercial banks. This protects the central bank from any risk of the borrower failing to repay what is owed.

Central banks apply a reduction to the value of the asset when they consider its value as collateral. This is known as a 'haircut', and is set according to the level of risk. One way to incentivise greener lending would be to increase the haircut applied to carbon-intensive bonds, signalling the higher risk that they carry. However, modelling suggests the impact of such an approach would be minimal. For a greater impact on lending, central banks could go much further and refuse to accept 'dirty' bonds from carbon-intensive companies as collateral at all.

3. Introduce lower interest rates for banks that fund green projects

Recent increases in costs and interest rates have created a difficult environment for renewable energy projects, which require high upfront investment. To address this, the Bank of England could introduce a 'term funding scheme' (TFS) for green investments – a dual interest rate policy meaning banks lending to green projects would have access to lower interest rates.

The New Economics Foundation (NEF) estimates that if the level of investment essential for the green transition goes ahead, firms' debt payments under currently forecast interest rates would amount to £13.7bn. NEF finds that the introduction of a dual rates approach could reduce this by 46%.

This is not a new idea: the Bank of England introduced a TFS in 2016 for lending to UK non-financial businesses, and a version in 2020 which incentivised lending to small and medium businesses. Japan and China already have green targeted lending schemes. A green TFS would enable a faster transition beyond fossil fuels, supporting long-term economic stability by reducing the UK's exposure to energy price shocks.

Mythbusting

Myth: *Central banks cannot act on climate because they must remain independent and monetary policy should be neutral.*
Reality: The Bank of England's inflation target is set by the government. The Bank also has a secondary responsibility to support government policy priorities. It has been clearly established in letters from the government that the Bank can consider climate change risks as part of its mandate. Given the right steer from government, therefore, additional climate measures such as the targeted green lending scheme outlined above could be introduced without altering the relationship between the Treasury and the Bank.

The concept of 'market neutrality', meaning central bank decisions should not distort markets, should be approached with caution. In reality, any intervention seeks to affect outcome, so cannot be neutral. For example, central bank purchases tend to be in the form of bonds, disadvantaging smaller companies which do not issue bonds. By ensuring bond purchases mirror the existing market structure, 'market neutrality' also reinforces the status quo, where carbon-intensive companies dominate. Both the Bank of England and the ECB announced in 2021 that they would apply a 'green tilt' to their corporate bond purchases. However, as both have since ceased buying bonds (and the Bank of England is controversially selling them back into the market), this has so far had little impact.

There is a wider debate about the success of central bank independence – a principle which only became part of the mainstream economic consensus towards the end of the 20th century. (The Bank of England was granted operational independence in 1998.) The rationale for independence is that monetary policy (controlling the money supply and the price of money, or the interest rate) should not be used for short-term political advantage. Critics argue that removing these issues from government control is anti-democratic: as has been apparent in recent decisions about interest rates, the Bank of England has enormous power over the economy, making highly political decisions about winners and losers with no direct accountability to the electorate.

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