UPDATE TO GREEN FINANCE STRATEGY – CALL FOR EVIDENCE

RESPONSE OF THE IMPACT INVESTING INSTITUTE

JUNE 2022

Background on the Impact Investing Institute

The Impact Investing Institute (the "**Institute**") was launched in 2019 with a simple mission: to accelerate the growth and improve the effectiveness of the impact investing market in the UK and internationally. Our vision is for lives to improve, as more people choose to use their savings and investments to help solve social and environmental challenges, while seeking a financial return. We want to see more capital contributing to the well-being of people and the planet – as set out in the United Nation's Sustainable Development Goals (UN SDGs) - and for capital markets to be fairer and work better for people and the planet.

We are an independent, non-profit organisation, and are part of the Global Steering Group for Impact Investment (GSG) network. Our Theory of Change describes how we plan to achieve change in the short-, medium- and long-term. We run a series of research, education and advocacy programmes designed to bring about the market conditions to enable impact investing to flourish.

This includes the following work with policymakers in the UK Government and regulatory bodies:

- As a member of the **UK's Transition Plan Taskforce's** Delivery Group, we are helping to ensure climate transition plans are robust, meaningful and, building on the recommendations of our G7 Impact Taskforce, acknowledge the necessity of delivering a Just Transition, incorporating not only environmental factors but social considerations and community empowerment, too.
- We act as secretariat to and are a member of the **Government's Stakeholder Discussion Forum** on green finance, supporting the UK's successful first two green gilt issuances in 2021. This followed our proposal for a Green+ Gilt, published in partnership with the Green Finance Institute and LSE's Grantham Research Institute, emphasising the strategic potential for a green sovereign bond to scale up the UK's drive to a net-zero carbon economy that also prioritises well-defined social and economic benefits.
- We co-ran the **Impact Taskforce**, in partnership with the Global Steering Group for Impact Investment and backed by the UK's G7 presidency in 2021, which identified three critical Elements of a Just Transition, applicable across all geographies, sectors, policies and investments. Our report details the actions that each Just Transition Element involves, and how investors and policymakers can contribute to their delivery.
- We sit on the **FCA's Disclosures and Labels Advisory Group (DLAG)**, providing advice for the development and implementation of new sustainability-related financial disclosure requirements and a classification and labelling system for sustainable investment products.
- Funded by the UK government, our **Place-Based Impact Investing (PBII) programme** seeks to encourage more investments with a positive local impact, with a focus on addressing the needs of specific places to enhance local economic resilience, prosperity and sustainable development. Our "Scaling up institutional investment for place-based impact" paper (May 2021), published in partnership with The Good Economy and Pensions for Purpose, has since been cited in several government reports, including the "Levelling Up the United Kingdom" White Paper.

Note on response

We have selected to answer those questions we deem most relevant to our areas of expertise. In some cases, we have provided a combined response to two or more questions.

Consultation response

Capturing the Opportunity

1. What are the key characteristics of a leading global centre for green finance?

In the context of this response, the Institute makes the following recommendations for promoting the key characteristics of a leading global centre for green finance:

1. Creation of a comprehensive bond standard that recognises the social co-benefits generated by green bonds, and continuous development of gilts and corporate bonds, including retail bonds, that align with this standard.
2. Integration of the concept of 'double materiality' into UK financial reporting standards.
3. Clarification of pension scheme fiduciary duties by DWP and DLUHC, to include consideration of the impact of investments on society and the environment. This would help mobilise more capital towards the transition, including helping government reach its target of 5% local investment by Local Government Pension Schemes.
4. Establishment of a Social Technical Advisory Group, compiled of institutional and social investors to advise on a comprehensive framework of social metrics for investors and businesses to apply.
5. Exclusion of natural gas activities in the UK's Green Taxonomy.
6. Inclusion of a robust 'impact' label, applicable to both listed and private markets, as part of the FCA's development of a sustainable finance labelling system.
7. Placement of private capital mobilisation at the core of the targets and remuneration structure (i.e., beyond only being part of the mandate) of financial institutions accountable to government (domestically and internationally, including those of which it is a shareholder), such as British International Investments, the British Business Bank and the UK Infrastructure Bank.
8. Support for such organisations to increase deployment of blended finance instruments and tools.
9. Integration of the concept of the 'just transition' in the transition plan frameworks being developed by the Transition Plan Taskforce.
10. Support for and encouragement of place-based impact investing, including by giving local government a clear mandate to take a local, place-based approach, and providing it with in-house expertise or the opportunity to use external professional support at little or no cost for early-stage projects.
11. Support for the mobilisation of capital at scale into emerging markets, including through initiatives that strengthen emerging market capital market infrastructure, size, and depth – e.g., the FCDO's MOBILIST programme.

6. What areas for potential growth – for example emerging financial products and instruments – are there in green finance for the UK financial services sector?

While the development of green bonds is already a key focus, there is still a gap for financial instruments that also target social impact or assign equal importance to social aspects. Bonds that target both green and social elements will support environmentally sound investments that also create high quality jobs and skills and contribute to "levelling up" regional inequalities in the UK, with local solutions targeting deprived areas and communities. Aside from the obvious social impact these bonds have, "levelling up" has the potential for its own financial rewards, through the encouragement of further economic development and opportunities.

In October 2020, the Institute published (in partnership with the Green Finance Institute and LSE's Grantham Research Institute) a proposal for a Green+ Gilt. The proposal emphasised the strategic potential for a green sovereign bond to scale up the UK's drive to a net-zero carbon economy that also prioritises well-defined social and economic benefits. The Institute's second paper on Green+ Gilts discussed how the UK's commitment to reporting on social co-benefits could be implemented in a practical, efficient and innovative way. The Institute continues to provide its support on this to government as secretariat for HMT's and DMO's joint Stakeholder Discussion Forum.

Going forwards, government should consider integrating social co-benefits in further issuances as standard from the outset, rather than reporting on them after issuance. Alongside the environmental and social impact, Green+ Gilts acknowledge and account for a wider range of financial risks and, therefore, provide an opportunity both for enhanced risk management and financial reward.

Government Green+ Gilts would also have a demonstration effect across the rest of the domestic economy and internationally, encouraging business as well as local authorities and other public agencies also to issue bonds that deliver green and social benefits. The Green+ framework could be adopted by other UK issuers, providing a template for further issuance. This would help to meet the growing demand from retail investors and institutional investors for high-quality assets that deliver positive social and environmental impact.

Financing the UK's energy security, climate and environmental objectives

7. How can the UK support a financial system that leverages private investment to meet the UK's climate and environmental objectives?

9. What barriers are there to unlocking private investment to support the UK's energy, security, climate and environmental objectives?

On the one hand, key barriers to unlocking private investment to support the UK's energy, security, climate and environmental objectives include a limited understanding of the risks and opportunities presented by environmental and social impacts, and the lack of robust, standardised frameworks and metrics by which to identify, manage and report on these risks and opportunities. Hence, key ways in which the UK can address these barriers and support a financial system that leverages private investment to meet its climate and environmental objectives are to (1) embrace a more holistic understanding of environmental and social risks and opportunities by committing to the concept of 'double materiality', (2) clarify relevant regulation and policy, such as pension scheme fiduciary duties,

to reflect this concept of ‘double materiality’, (3) develop and implement robust impact management frameworks, including both green and social taxonomies, and (4) develop and implement a robust labelling system that includes an impact category.

Double materiality

The UK can make it easier for private investment to help meet the country’s climate and environmental objectives via a commitment to the concept of 'double materiality'. We note and welcome the EU's commitment to 'double materiality' in their guidelines for non-financial reporting and the Sustainable Finance Disclosure Regulation ('SFDR') (defined therein as ‘principal adverse impacts’). We urge the UK and the FCA in particular to consider adoption of a 'double materiality' standard – requiring market participants to report on outcomes that are material for society, the environment and the economy, even if they are not yet material for enterprise value creation.

The basis for this concept is that materiality is dynamic. A market participant's impact on people, the planet or the economy can rapidly affect enterprise value, asset pricing and capital allocation decisions, and an evolving economic landscape means that what appears financially immaterial today can quickly prove to be business-critical tomorrow. Requiring market participants to report fully on their positive and negative sustainability impacts serves the public interest, enables all stakeholders to better assess the wider environmental and social impacts of organisations, and assists market participants in addressing negative impacts, maintaining or enhancing value at enterprise as well as broader social and environmental levels.

We believe that a more complete understanding of a market participant's environmental and social impact is a critical and necessary precursor to the enhanced market integrity that the UK is seeking to achieve in supporting a financial system that leverages private investment to meet the UK's climate and environmental objectives.

Fiduciary duties

A key way in which the concept of ‘double materiality’ can be reflected in regulation and policy is in changes to the duties of pension scheme trustees – or, in the case of Local Government Pension Schemes, administering authorities.

In a pension fund context, fiduciary duties are to be exercised to serve the purpose of the pension fund – to provide retirement benefits for its members. This basic duty is supplemented by additional investment duties set out in legislation, including considering the best long-term interest of scheme beneficiaries. This means consideration of a wide range of factors such as the appropriate diversification of assets, the time horizon of investments and matching assets to liabilities or cashflows, as well as managing risk in the trust’s investment portfolio. Environmental, social and governance factors and impacts should be included in these considerations. However, in practice, pension schemes generally understand their purpose to be to “maximise the returns from investment” and “make the pursuit of a financial return their predominant concern.”[1] This pursuit of highest possible returns means that there is little consideration of the wide range of other factors relevant to pension planning, including the impact of environmental and social factors on scheme investments,

[1] *Local government pension scheme: guidance on preparing and maintaining an investment strategy statement (July 2017)*

as well as the scheme's own impacts – through its investment decisions – on the environment and society.

To address this, fiduciary duties need reframing to accommodate the twin realities that, on the one hand, environmental and social factors represent financial risks, and, on the other hand, these risks are themselves caused by the impacts of company and investor (and wider societal) activities (i.e., double materiality). This can be achieved by changing regulation to explicitly require schemes, when selecting scheme investments, to consider the impact of those investments on the financial system, the economy, communities and the environment.

Impact frameworks

In order to support and underline the importance of social factors, government should consider establishing a Social Technical Advisory Group to advise on a social metrics framework, comprising business, institutional investors and social investors. This would complement the work of the Green Taxonomy Advisory Group, anticipate the impact of the EU's work on a Social Taxonomy, and demonstrate how social factors can be given equal importance to green factors by the UK government.

We also oppose the possible inclusion of natural gas activities in the UK's green taxonomy, in alignment with a letter recently published by the Institutional Investors Group on Climate Change (IIGCC), Principles for Responsible Investment (PRI) and UK Sustainable Investment and Finance Association (UKSIF). As the organisations outline, short-term considerations on energy security must not be conflated with the taxonomy, and any inclusion of gas risks sending 'misleading signals to investors' at a time when they need greater clarity.

Labelling system

As a member of the FCA's Disclosures and Labels Advisory Group (DLAG), we are supporting the FCA's ongoing efforts to develop a sustainable finance labelling system. This includes the creation of an 'impact' label, which we believe can protect market integrity, improve communication between investment managers and consumers, and further underline the UK's leadership role in impact investing worldwide. As part of our engagement with the FCA, we have responded to its discussion paper "DP21/4: Sustainability Disclosure Requirements (SDR) and investment labels", and are strongly advising that an 'impact' label should be applicable to both listed and private market investments.

Financing Transition Activities

12. Are there barriers to the mobilisation of private investment into transition activities? If so, what are they and how might they be overcome?

13. How can the UK become a leading hub in structuring and innovating on transition finance?

14. Is there a role for the UK government to support the development of transition finance markets in the UK and internationally?

Given the overlapping themes of questions 12, 13 and 14, the below sets out a combined response to the three questions.

The Institute believes that there are multiple external and internal investor barriers that currently limit the flow of potentially transformational capital held by private investors to support the transition to Net Zero. Private investment in the transition to Net Zero is needed both in the UK and in emerging markets. In both the domestic and international contexts, many of the barriers holding institutional investors back can be overcome with existing tools and instruments. Successful approaches and modalities need to be expanded so that more institutional investors can participate and deploy capital.

Most of these barriers apply universally, but some are particularly relevant for certain asset classes, such as ratings for fixed income and private debt offerings. Similarly, while most barriers set out below affect all institutional investors, some present more significant impediments to those with a particular regulatory status.

The barriers below are also relevant to question 38, below.

External barriers to the mobilisation of private investment into transition activities include:

a. **Real or perceived investment risks**. In domestic markets, these include changing political or policy decisions, the sensitivity of a sector to regulatory change, exposure of a sector's revenues to fluctuations in interest rates, exchange rates, inflation and/or changes to the tax system, operational or delivery risk (for example if a project is subject to planning permission), as well as commercial risks related to the reliability of revenue streams. Similar barriers exist in emerging markets but might be felt more keenly, such as greater political and economic instability, which can be exacerbated by lack of quality. Data. There are also legal risks, such as unenforceable or weak property rights, restrictions on repatriation of capital, weak bankruptcy and insolvency frameworks and limited minority shareholder rights. Foreign exchange risks are also often substantial.

b. **Lack of size and pipeline.** Direct investment opportunities in transition activities are often too small for institutional asset owners and managers to consider. Looking at opportunities that explicitly pursue positive local impact, the challenge becomes even more pronounced. As well as the challenges of finding appropriate scale, the pipeline of investable projects coming to the market is limited.

c. **Lack of reliable information.** Private investments often provide non-standardised, limited and, at times, unreliable information. This presents challenges across the investment cycle, but particularly during the due diligence assessment of an investment opportunity.

d. **Lack of liquidity.** In private equity, the immaturity of investment markets in most emerging market jurisdictions restricts visibility on exit opportunities. Consequently, some investors automatically charge liquidity premiums to transactions without acknowledging the potential matching of their long-term liabilities with the long-term investment opportunities.

e. **Lack of ecosystem of suitable intermediaries.** Historically, institutional investors have typically worked with asset managers and consultants with whom they have long-standing relationships. These managers and consultants are usually focused on liquid asset classes in highly sophisticated markets. Impact managers, who are focused on generating positive environmental and social benefit alongside a return, while building track record and gaining

market momentum, have historically been rejected by asset owners as lacking adequate size and track record.

f. **Statutory and general law duties and regulatory requirements.** Institutional investors' mandates are often directly or indirectly restricted by regulatory oversight and requirements. For example, pension schemes trustees need to meet their fiduciary responsibilities, which are often perceived to limit focus to purely financial returns, preventing many schemes from achieving, through investment decisions, positive, real-world impacts on the environment and society, as discussed in greater detail in response to questions 7 and 9. Institutional investors must also comply with the various statutes and laws that govern them.

g. **Credit ratings.** In a UK context, the organisations and vehicles contributing positively to a Just Transition can struggle to become investment-grade given their limited operating histories. That challenge is replicated and compounded in emerging markets, where sovereign ratings are generally sub-investment grade.

h. **Costs.** Private market transactions are often expensive to execute, particularly when they are being undertaken as a new activity for an investor. While building the experience and knowledge base inside an investment organisation, underwriting deals may require extensive support from external advisors. Impact transaction management can further add to the overall costs of an investment.

Internal barriers to the mobilisation of private investment into transition activities include:

i. **Limited risk appetite.** Institutional investors' mandates usually default to very limited risk taking, often encouraged by regulatory requirements. This limits their ability to invest in illiquid investments that are perceived as risky, especially within emerging markets.

j. **Rigid allocation policies, guidelines or frameworks and mandate restrictions.** Allocation policies and frameworks often do not account for private 'alternative' assets and/or emerging markets. Changing such frameworks often requires significant effort and time.

k. **Lack of awareness and access.** Institutional asset owners often lack the required networks and market connectivity to source suitable pipeline.

l. **Staff capabilities, expertise, and market familiarity.** Institutional investors often lack in-house expertise to analyse specialist or private market investments, or investments in emerging markets. When extending their investment focus, additional resources (which may not be readily available) need to be allocated including to what extent investors should look to specialist intermediaries for help, build in-house expertise, or adopt a combination of the two.

m. **Incremental effort.** Private transactions, and those in emerging markets especially, usually require more time, effort, and specialist expertise to identify, perform due diligence on, execute and monitor deals, demanding more human capital investment. Given the need to consider risks which may be less familiar to the asset owner, specialised external advisors are generally required, including local legal counsel and accounting and sector experts.

Consequently, many asset owners charge a 'complexity premium' or similar underwriting fees, adding to the overall costs of these deals.

Actions that the UK government could take to support the development of transition finance markets in the UK and internationally, including facilitating structuring and innovation:

- **Blended finance.** Blended finance plays an important role in addressing risk/return barriers. Blended structures can provide investors with the opportunity to increase portfolio exposure into strategies which demonstrate strong fundamentals but may have historically been associated with high perceived risk. While blended finance has been traditionally used to mobilise capital into emerging markets, there is increasing evidence of the usefulness of this approach for investments into the UK as a means of financing transition activities, including finance for green infrastructure and development of the labour market in response to the transition.

  Government can lead the way by supporting the further deployment of the many proven blended finance instruments and tools that can demonstrably help mobilise institutional capital at scale for the transition. These include supporting the roll-out of: (i) subordinated capital; (ii) guarantees; (iii) insurance; (iv) securitisation; (v) performance data; (vi) information and partnerships and, in the context of emerging markets, (vii) local currency financing.

  Perhaps the most promising tools are the increased use of guarantees and insurance coverage at a portfolio and vehicle level, as they allow for unfunded risk mitigation. By protecting against the risk of non-payment, guarantees can, for example, enable a financing proposition to achieve an investment-grade rating where it otherwise would have been unable to. This, in turn, can make a transaction acceptable to a broader range of investors. Guarantees can also be used to free up capital on an institution's balance sheet, allowing it to extend new loans and therefore deliver more impact.

  Government is encouraged to expand its use of these tools both domestically and in emerging markets, so that more institutional investors can participate and deploy capital for the transition. Incentivising quasi-state actors like British International Investments (BII) and the UK Infrastructure Bank (UKIB) appropriately to use and develop blended finance instruments should also be considered (see next bullet).

- **Mandate to mobilise private capital.** Government can support market activity and innovation by putting private capital mobilisation at the core of the mandate, targets and remuneration structures of financial institutions accountable to it (including those of which it is a shareholder), such as BII, UKIB, the British Business Bank (BBB), and others, by:

  - working to amend the objectives of these banks and agencies to make capital mobilisation an objective of equal weight as balance sheet investment; and
  - structure incentive mechanisms so that every mobilised pound receives as much recognition as every pound invested on the organisation's own account.

Making mobilization of institutional capital an objective equal with balance sheet investment will have implications for the business models of these institutions. The Institute would therefore invite government to provide additional financing and support to:

- strengthen the mandate within domestic institutions such as the BBB UKIB, Homes England and others to leverage private capital;
- strengthen the role BII, the Private Infrastructure Development Group (PIDG) and multilateral development banks play in developing market infrastructure in emerging and frontier markets and assisting market actors to establish new investment vehicles;
- strengthen the balance sheets of existing providers of guarantees;
- invest in other existing and new entities that can provide guarantees, including by replicating existing guarantee provider models (e.g., GuarantCo and InfraCredit) in emerging markets, and requiring a minimum guarantee capacity of $1 billion and a target guarantee ratio of five to 10 times that capacity;
- expand project pipeline development and generation of primary investable opportunities which create social and environmental benefit alongside financial return in domestic and emerging markets;
- expand the investment tools within all of these institutions – especially those that can address the risks (real and perceived) faced by institutional investors in investing in transition opportunities;
- expand the ability of all these institutions to provide concessionary capital that can participate, and act as catalytic capital in blended finance solutions alongside institutional investors; and
- encourage these financial institutions to, where appropriate, package and sell relevant mature and strong-performing assets in their portfolio – whether directly or through securitisation and other instruments. Enabling institutional investors to acquire proven assets from more specialist organisations will help stimulate participation and in turn help to build secondary market activity.

- **International partnerships and initiatives.** Government should work with its global counterparts to ensure these barriers are lifted in their own markets, so local pools of capital can contribute to transition finance. Many of the tools which can be used to do so are replicable across the UK and emerging markets. For example, the UK government has a huge amount of influence in setting the strategic objective for financial institutions which are central to the development of just transition markets. This influence comes either from a position as ultimate owners, sole shareholder or key shareholders of those institutions listed above.

  Government should also support its counterparts in developing countries in strengthening their own legal and regulatory systems so these markets can be regarded as reliable and accessible for institutional investors – both domestic and international. It can do this by:

  - helping other countries to emulate the UK's world-leading initiatives, such as the Transition Plan Taskforce;

- backing the recommendations of the Impact Taskforce, that was mandated by the UK 2021 G7 Presidency to support the development of scalable financial vehicles that harness private capital for public good, with an emphasis on emerging markets; and
- continuing to support joint initiatives with other jurisdictions, such as the Glasgow Climate Pact at COP26, which reconfirmed the need to significantly increase support for developing countries beyond $100 billion per year, and the Just Energy Transition Partnership that France, Germany, the UK, the US, and the EU announced with South Africa, pledging an initial commitment of $8.5 billion over the next five years to support the country's decarbonisation efforts.

- **Transition plans.** The UK government's upcoming requirement for every UK financial institution to have a Net Zero transition plan, as well as the work of the Transition Plan Taskforce, provide a clear opportunity to set a global gold standard for transition finance. As a member of the Transition Plan Taskforce's Delivery Group, the Institute is helping to ensure climate transition plans are robust, meaningful and, building on the recommendations of our G7 Impact Taskforce, acknowledge the necessity of delivering a Just Transition, incorporating not only environmental factors but social considerations and community empowerment too.[2]

- **Fiduciary duty.** Regulators should ensure that definitions of fiduciary duty are not a barrier to investors considering the impact of investments on society and the environment. Regulation should encourage and support institutional investment in transition activities, particularly in private investments (private equity, debt, real estate and infrastructure), acknowledging in particular the illiquidity of these investments and the greater commitment of resources required to transact and maintain them.

Ensuring Broad Access to Green Finance for Local Authorities, SMEs and Retail Customers

The following answers are especially informed by our work on Place-Based Impact Investment, in particular our reports, Financing structures for place-based impact investing – what works? and, produced in partnership with Lloyds Banking Group, Building Strong Places: a new, impactful role for financial institutions. This work builds on the significant foundations of the many organisations which have established the UK as pioneers in this space, particularly in the social investment sector.

17. How can the UK financial sector support the delivery of the UK's climate and environmental objectives at the local level, whilst also benefitting local growth and communities?

Place-based impact investing, where financial institutions invest in sustainable projects at a local level, is an approach which contributes to solutions for challenges which are both local and global, as well as environmental and/or social. A place-based impact investing approach allows financial institutions to take on a meaningful role in delivering the UK's climate and environmental objectives, whilst also contributing to projects which improve people's lives, contribute to local economic resilience (i.e., "levelling up") and generate appropriate, risk-adjusted financial returns.

[2] *https://www.impactinvest.org.uk/press-release-hm-treasury-launches-uk-transition-plan-taskforce-with-impact-investing-institute-as-a-member-of-its-delivery-group/*

There are significant funds that could be unlocked by the UK financial sector supporting and encouraging place-based impact investing. For example, if Local Government Pensions Schemes achieve the 5% target for allocations to local investment outlined in the Levelling Up White Paper (February 2022), and recommended by the Impact Investing Institute, this would unlock £16 billion for place-based investments, more than matching public investment in levelling up.[3]

In order to adopt a place-based impact investing approach, the UK financial sector should:

- shift focus from individual transactions towards a longer term, place-based portfolio approach which explicitly seeks out place partnerships;
- dedicate financial and human resources to a new place-based impact investing approach, including engaging active and visible senior-level support as well as specialist resources;
- focus on a select number of place-based relationships, rather than a broad selection, since deepening ties in particular locations will lead to a greater understanding of local contexts and challenges, thereby enabling the creation of replicable models that can be scaled up as well as transferred to other places;
- design financial models that can overcome barriers to investment (such as scale) and promote enhanced positive social and environment impact (see our answer to Qs 12-14 for detail on how); and
- work together with local partners to crowd in other sources of funding at a local level where appropriate.

18. How can local authorities support the mobilisation of private and public investment to key sectors and technologies for the UK's climate and environmental objectives, whilst also meeting local priorities? What barriers to this are there?

The engagement of local authorities is key to ensuring that any development of place-based impact investing by financial institutions is developed in a way that is not only viable but as beneficial as it can be to that specific local community. Local government can support the mobilisation of private and public investment, whilst also meeting local priorities by:

- articulating clear development priorities and a vision for their local area, as well as developing ways of communicating these aims to financial institutions;
- committing resources to engaging with private sector partners, both on overarching strategy and detailed commercial negotiation, including provision of the information that financial institutions will need to rely on, to encourage the development of the types of local partnerships that are key to long-term place-based impact investing; and
- ensuring that local people are involved in each stage of the process when working with new financial partners.

Please see our answer to question 19 for an explanation of the barriers.

19. What is the current state of capability within local authorities to attract investment, and how can it best be supported?

[3] *Scaling up institutional investment for place-based impact*

There are four key barriers to attracting investment currently within local authorities:

a. **Information**. There are significant information and capability gaps in local authorities, including:

   - the ability to measure and articulate the social or environmental value of a project;
   - standard or template business cases so that project owners within local authorities do not have to start from scratch for every project;
   - appropriate governance processes for innovative projects;
   - understanding of the desired risk, return, liquidity, scale or term of an investment for different investor types as well as how decisions at financial institutions are made;
   - contacts within financial institutions or investors; and
   - development of co-investment models, which can go some way to addressing any political uncertainty (frequently a risk that is hard to quantify for investors).

   Much of this information could be provided to local authorities to kick off the process of developing capabilities at a local level. Government has a role in resourcing the appropriate organisation to provide that information (whether a government department, or a standalone commissioned project). Local authorities should also be encouraged to share best practice as they often lack information on how other places have tackled similar issues.

b. **Capital**. There remain basic barriers to attracting investment at a local level. The balance of risk and return for particular investments may not be attractive enough to financial institutions, and public procurement rules make it hard for investors to navigate the landscape. Procurement rules – which local authorities are understandably nervous of breaching – disincentivise early-stage partnership and development work. This is because a financial institution could put significant resource and expertise into co-designing an investment opportunity in a particular place, only to have absolutely no guarantee of becoming the local authority's investment partner because the opportunity has to be competitively tendered. Clarity and reassurance for both local authorities and financial institutions on these aspects would be crucial in supporting more place-based impact investing.

c. **Capacity**. While local government is run by many highly competent people, they often lack the time to look into attracting external investment. Using external professional support is often not an option due to requirements for it to be specifically linked to a particular project with a high likelihood of getting funded. This isn't usually possible within the early stages of investment pipelines. Providing local government with in-house expertise or the opportunity to use external professional support at little or no cost for early-stage projects will be key to ensuring that they have the ability to develop as required to support place-based impact investing.

d. **Skills**. Local authorities do not typically have an investment mindset and they lack financial expertise or the ability to judge investments. This is simply not part of their job description and local authority officers speak a different language to finance professionals. This gap is

exacerbated in more deprived areas where it can be difficult for local authorities to attract and retain commercial talent, meaning those officers typically become concentrated in urban centres. This gap in skill can also lead to unbalanced negotiations between local authorities and prospective private sector partners. This is, of course, inextricably linked to the capacity gap discussed above.

Local authorities need access to investment experts and senior relationship managers who are comfortable with bridging the gap between investment concepts and local government. They also require technical support, for example with market analysis, modelling, business plan writing and impact measurement (and developing other crucial information as discussed above) as well as property sector technical support. Access to this support would then also allow local government to develop their own skills in these areas and train and develop in-house support.

There are a number of ways in which local governments could access this support, whether through a new, centrally-run but regionally-focused team, or through a consortium model (taking the example of the Inclusive Growth Network run by the Centre for Progressive Policy).

20. How can the UK financial sector support SMEs and retail customers to align with the UK's climate and environmental objectives?

Support for retail customers can be achieved through Green bonds (as discussed in question 6). These bonds allow retail investors to align with the UK's climate and environmental objectives and also support local investment. The UK's green gilt plans included a retail NS&I bond, which the Institute strongly supported. We would encourage continuous development and support of such financial products, including the integration of investment in and reporting of social co-benefits.

21. Is there a role for the UK government to facilitate broad access to green for local authorities, SMEs or retail customers? If so, what should these roles be?

UK government is particularly key in facilitating broad access to green for local authorities, by providing the capability support they need to engage with financial institutions with regards to information, capital, capacity and skills (please see above answer to question 19).

Aside from filling the gaps that local authorities need to develop local investments, government can help in several other ways.

a. **The Green Finance Institute's campaign on Local Climate Bonds** seeks regulatory change to the Innovative Finance ISA legislation that would allow local authorities access to a new pool of capital to further support financing for climate-friendly projects, thereby further stimulating the economy through increased local investments and encouraging collective climate action.
b. **Deployment of tools and incentives to mitigate capital risks through blended finance.** This could be done through guarantees, subordinated capital or even making the leverage of private finance an explicit goal of investment by the UK Infrastructure Bank and of British

Business Bank programmes. This would aid in reducing the basic capital barriers to local investment. (Please see answer to questions 12-14 for further information.)

c. **Give a clear mandate to local government in taking a local, place-based approach and reform local funding** to address the delivery cost of funding public investments and building local capacity. Government needs to give clear guidance to local government in this area and provide unequivocal support in order to dispel nervousness in local government at the idea of developing these new approaches.

Greening the Financial System

27. What market barriers are there to the integration of environmental-related factors into financial decision-making?

Please see our response to questions 7 and 9 above.

28. What should the role of the UK government or regulators be to support the greening of the financial system? How could they go further?

Please see our response to questions 6, 7 and 9 above.

Leading Internationally

The following answers are especially informed by our work as co-leader of the 2021 UK G7's Impact Taskforce. The Taskforce's mandate was to develop actionable pathways for mobilising greater amounts of capital to invest in solutions to help meet the long-term needs of people and the planet. The Impact Investing Institute's workstream focused on instruments and policies for financing the SDGs and a Just Transition.

Our report, 'Mobilising institutional capital towards the SDGs and a Just Transition', presents these pathways. It is based on engagement with 170 influential stakeholders representing over 110 organisations based in almost 40 countries.[4]

33. Up to 2030, how can the UK government best support the global transition to a net zero, nature-positive financial system that is both inclusive and resilient?

The climate crisis is one of the defining challenges of our time. But there is growing consensus that a single focus on achieving net zero emissions is not enough. To be successful, climate action also needs to address the socio-economic impacts of moving to Net Zero – from potential job losses to rising household energy prices. It needs to be recognised that the impacts of climate change tend to disproportionately affect those in poverty and can exacerbate existing inequalities. To gain support and avoid social tensions or unrest, the transition to Net Zero needs to be fair – and seen to be fair – across regions and across the socio-economic spectrum.

A Just Transition therefore needs to consider:

[4] *Summaries of key findings and actions for each stakeholder group are available here https://www.impactinvest.org.uk/project/just-transition-finance/*

1. Different climate transition and planet preservation strategies across sectors.
2. Geographic disparities, needs and priorities at international, regional and national levels.
3. Affected, underserved and marginalised communities, households, workers and enterprises.

Financing a successful and sustainable global transition to Net Zero requires a clear and shared understanding by all market actors as to what constitutes a Just Transition. The Impact Taskforce identified three critical Elements of a Just Transition, applicable across all geographies, sectors, policies and investments.

To support a Just Transition, initiatives should include the three elements of:

1. advancing Climate and Environmental Action;
2. improving Socio-economic Distribution and Equity; and
3. increasing Community Voice.

The Impact Taskforce's report details the actions that each Just Transition Element involves and the investable opportunities/strategies that investment vehicles might focus on to achieve them. By subscribing to these Just Transition Elements and integrating them into dialogue, policy-planning and legislation at all levels, the UK government can make clear what 'good looks like' and therefore help spur concerted, focused and effective action.

34. How can the UK government increase the mobilisation of public and private investment to achieve 2030 climate and nature targets in emerging and developing economies?

Reducing and absorbing carbon emissions at the speed and scale needed to safeguard our planet requires vast amounts of capital. The global costs required to achieve 'Net Zero' carbon emissions have been variously put at $1.6 trillion to $4 trillion a year. Governments and the public sector alone cannot meet these huge capital requirements. More of the $154 trillion held globally in private pensions, insurance policies, endowments and other institutional arrangements urgently needs to be deployed in investments that can help drive a global transition to Net Zero.

As highlighted in questions 12-14 above, as a regulator, the UK is encouraged to examine and address all barriers restricting participation by UK institutional investors, particularly pension funds and insurance companies, in investments that support the transition to Net Zero. Industry regulators should ensure that definitions of fiduciary duty are not a barrier to investors considering the impact of investments on society and the environment. Regulation should encourage and support institutional investment in transition opportunities in both the UK and emerging markets, and private investments (private equity, debt, real estate and infrastructure), acknowledging in particular the illiquidity these investments involve and the longer time commitment they require from investors.

In addition to removing such barriers domestically, the UK government should also work with its global counterparts to ensure these barriers are lifted in their own markets so local pools of capital can contribute to transition finance.

Further information is set out in response to questions 12-14.

35. How should the UK government assess and measure progress towards the transition of the global finance system and mobilisation of finance for global climate and nature goals

The UK should put tracking progress in mobilising capital for the transition on the agenda at successive G7 meetings and COPs, holding all actors of the global system to account. The Government should also continue to push for the ongoing development of international impact reporting standards that enable and require activity and progress to be compared by country, sector or company, based on the impact transparency, harmonisation and integrity principles put forward by the impact measurement working group of the G7 Impact Taskforce.

Supporting an Inclusive Transition in Emerging and Developing Economies

38. What are the unique challenges for emerging and developing economies in meeting the requirements of the transition to net zero and nature-positive global financial system, and how can the UK best provide support to overcome these?

The unique challenges include a lack of mature public, regulated markets in emerging economies. Public investment refers to securities available on an exchange or an over-the-counter market. Public exchanges in developed economies are highly regulated and provide investors with daily liquidity and stringent governance and reporting standards. Companies that issue listed securities are usually of a certain size and maturity and all these features are intended to reduce risk for investors. Consequently, shares and bonds publicly listed in developed markets are generally considered the backbone of financial markets and tend to make up the lion's share of institutional asset allocation.

However, the majority of emerging markets entirely lack public markets. Where they do exist, they are mostly small and provide access only to a few large corporations and banks. These markets often do not meet developed markets' standards and criteria and operate with very thin trading volumes that limit participation by institutional investors. For example, in terms of equities in emerging markets, there are about 70 major stock exchanges globally trading assets with a total market capitalisation of $113 trillion as of June 2021. Of these exchanges, 15 have a total market capitalisation of over $2 trillion – none of which are located within Africa or Latin America.

Fixed income in emerging markets is also a challenge as the distribution of emerging market fixed income is limited by its credit profile. Often, assets with sub-investment grade credit ratings cannot be held by institutional investors, particularly insurance companies. This gap creates significant challenges for institutional investors looking at emerging markets, as the majority of the more frontier economies are rated sub-investment grade or deeply speculative.

To provide support to overcome these challenges, the UK government needs to encourage emerging markets issuers to attract more institutional capital at a transactional level, both from within their domestic capital markets and internationally. Another course of action is to see how emerging markets generally can strengthen their capital markets' infrastructure, size, and depth to allow for continuous flows of investment in listed equities and bonds – for example through FCDO's MOBILIST programme.

As discussed in relation to transitional activities in the Institute's response to questions 12-14 above, institutional investors face real and perceived barriers to participating in emerging markets' private transactions. Such barriers can be classified as either external or internal. Most apply across asset

classes, but some are particularly relevant for certain asset classes, such as ratings for fixed income and private debt investment offerings. Similarly, while most barriers detailed affect all institutional investors, some present more significant impediments to certain institutional investors because of their regulatory status. For capital to move at scale, these barriers need to be acknowledged and adequately addressed. These are set out in our response to questions 12-14.

Mobilising Finance in Emerging and Developing Economies Using Green Bonds

39. Considering the key market incentives and barriers, how can the UK best support an increase in high quality, green bond issuances for emerging and developing economies?

The UK can support bond issuances for emerging and developing economies by encouraging green bond innovation and being leaders in sustainable finance. The further development of so-called "Green+" bonds (which include the social co-benefits of green investment) is crucial to this leadership, as such financial products will be hugely beneficial for emerging and developing economies. The UK has the resources to pursue such green bond innovation by establishing and developing these financial products, thereby setting an example for other emerging and developing economies. Without the development and support of such financial products by countries with the resources, it will not be achievable for emerging and developing economies to replicate and rely on them.

The UK has a significant near-term opportunity to steer the size, standards and momentum of the green bond market towards including social factors. Financial products that properly account for social and local factors are likely to benefit emerging and developing economies even more than the UK. There are key barriers that still need to be overcome in making such financial products reliable (as discussed above) and the UK has the resources to lead in this development to create a model that can be used globally.