

# Consultation response: House of Commons Environmental Audit Committee's 'Green finance' inquiry

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# Consultation response: 'Green finance' inquiry

## Introduction: what is this consultation about?

The House of Commons Environmental Audit Committee launched its inquiry on 'green finance' in November 2017, to 'scrutinise the Government's strategy to develop "world leading Green Finance capabilities"' (Environmental Audit Committee, 2017).

This submission outlines the latest research evidence from the the ESRC Centre for Climate Change Economics and Policy and the Grantham Research Institute on Climate Change and the Environment at the London School of Economics and Political Science, in order to answer a number of questions from the terms of reference of the inquiry.

## Recommendations

**Is the Government's level of ambition on green finance – and the mechanisms it sets out in the Clean Growth Strategy – sufficient to generate the investment needed for the UK to meet its environmental commitments?**

**Response:** There are concerns about funding for sustainable infrastructure and renewable energy given the uncertainty around the future role of the European Investment Bank (EIB) and the Green Investment Bank (GIB). It is also unclear from the Clean Growth Strategy whether or not the Government will implement the recommendation of the Task Force on Climate-Related Financial Disclosures (TCFD) in encouraging private sector disclosure of climate-related financial risks. These concerns are outlined in more detail in the responses below.

In addition, the policy outlined in the Clean Growth Strategy to 'Work with mortgage lenders to develop green mortgage products that take account of the lower lending risk and enhanced repayment associated with more energy efficient properties' should be reviewed in more detail.

Supporting energy efficiency can be an effective way of reducing energy costs for households and businesses while also reducing carbon emissions (Committee on Climate Change, 2017; Department of Energy and Climate Change [DECC], 2014). However, it is important that policymaking on the topic of green mortgages is based on robust evidence and is realistic about the impact of the proposed intervention.

The claim that energy-efficient households have lower mortgage default risk is intuitive, but it needs better empirical corroboration. Robust empirical analysis on the relationship between energy efficiency and mortgage default is limited, with one study from the US often cited (Kaza et al., 2014). There are several concerns with drawing conclusions from this study that would be applicable to the UK, the primary of which is whether or not the study presents a sufficiently convincing case for causality – that is, if higher energy efficiency is indeed the explanation for better repayment behaviour. Evidence suggests that energy efficiency measures tend to be adopted by those with higher incomes as well as those with greater concern for the environment (Allcott et al., 2015). Higher income is also associated with better repayment behaviour. Kaza et al. (2014) try in part to control for this by using credit scores and average income, but there are concerns over the technicalities of how this was done (the authors did not have access to household-level data on income and so were using average incomes by US zip code). This raises the possibility that income or another underlying omitted variable is associated both with energy-efficient mortgages and lower default risk. Also, given that the study is based on 75,000 owner-occupied US households largely concentrated on the east coast, it would be preferable to have more evidence before concluding that the results are generalisable to other geographies.

Given the limitations of the US study, it would be useful to have UK-based evidence before asserting that green mortgages have a lower default rate. We therefore welcome BEIS's proposal to replicate the US study in the UK (see BEIS, 2017).

The Government should focus on identifying the most significant barriers to energy efficiency, including not just the availability of supply-side schemes, but also their design. As noted in the Grantham Research Institute's response to the Government consultation on the Green Deal Framework (McCoy and Neuweg, 2017), consumers offered financing for energy efficiency did not take up the offer as anticipated, in part because of a lack of awareness, administrative complexity and because the interest rates offered were not sufficiently attractive.

The growing rental market in the UK also creates mismatched incentives, as the renters that would benefit from lower energy costs are not the ones taking out mortgages. So while encouraging the private sector to develop green mortgage products could be useful, on its own it may not be sufficient to address the need for energy efficiency improvements.

The Government should focus on more research about the link between green mortgages and defaults before advocating policy action. Efforts to encourage energy efficiency via green finance should also look at the design of the scheme on the supply side, and link up with government policies to increase demand for energy efficiency, for example through raising minimum standards for rental properties.

### **Is the Green Investment Group (GIG) fulfilling commitments made by Macquarie to ensure the Bank 'remain[s] one of the leading investors in green infrastructure in the UK and Europe'?**

**Response:** Concerns about asset stripping after privatisation depend a great deal on what happens to the proceeds. Macquarie is one of the largest investors globally in renewables (Macquarie, 2017). Selling some of the more mature projects to re-invest in earlier-stage technologies arguably could be desirable and crowd in new capital, whereas distributing the profits as dividends to shareholders, for example, would not (E3G, 2017). Given Macquarie's international focus, this also raises the question of whether or not it will continue to focus investment in the UK specifically.

Besides offering direct investment, the GIG as a public entity helped crowd in private sector investment: involvement of the government-backed bank reassures investors that projects have been vetted. For every £1 the GIB invested, it mobilised another £3 in private sector investment (Green Investment Bank, 2016). One question is whether, after the bank's privatisation, the Green Investment Group will fill a similar role in crowding in other investment by providing expertise and reassurance on larger or riskier projects, or whether it will be competing with other private sector actors for similar projects with a low risk profile.

At this stage, the privatisation is too new to offer sufficient data from which to draw conclusions. However, the Government should carefully monitor whether the special share arrangement is fulfilling its purpose, and whether larger or riskier investments need government support by other means.

### **What options are there for the UK's future relationship with the European Investment Bank? What would be the implications for green investment in the UK?**

**Response:** The UK's relationship with the EIB is still uncertain. Possibly the UK can still benefit from EIB funding, either through a special relationship with the EU or through a new offshoot of the EIB focused on international investment (Jones and Guarascio, 2017; Stone, 2017).

The EIB committed £1.2 billion in renewable energy investment in the UK in 2016 (EIB, 2017b). While the EIB is seen as less important for financing mature technologies, it plays a role in providing liquidity in larger projects and credit guarantees (Business, Energy and Industrial Strategy

Committee, 2017; EIB, 2017). Without this support, the private sector may have to step in, increasing the cost of debt (Business, Energy and Industrial Strategy Committee, 2017).

A future lack of EIB support may also affect other priority areas in funding small and medium-sized enterprises (SMEs) and regional growth, which the EIB has made a point of investing in (EIB, 2016) and which are both pillars of the UK Industrial Strategy. For example, funding for Welsh infrastructure could be affected if the UK stops working with the EIB, both because of a lack of funds and because the funds may be directed to other geographical areas in the UK (Mor and Ward, 2017).

### **How effective are the Task Force on Climate-related Financial Disclosures' (TCFD) recommendations likely to be at moving investment into 'clean' sectors?**

**Response:** While the TCFD's (2017) recommendations are a welcome first step, they face challenges in implementation and design: the voluntary guidelines may not be sufficient to generate comparable data across companies. Disclosure is only part of a larger challenge of integrating climate risk into operational decision-making and will not alone be sufficient to finance the low-carbon transition without interest from investors and a generally supportive policy framework, for example including carbon pricing and support for renewable energy.

The current TCFD recommendations give considerable leeway in some areas where more detail will be needed for consistency. For example, the TCFD outlines options and guidelines for scenario analysis, while ultimately leaving it to the individual company to decide how it will implement the guidelines, including the selection of scenarios that it uses to assess risk. Voluntary guidelines may not be sufficient for widespread and comparable disclosure, as explained in more detail in the responses to the next question.

The effectiveness of disclosure may also be undermined by a mismatch in timescales. Under existing financial disclosure rules and industry norms, companies report their outlook for the upcoming year, whereas climate risks may manifest themselves further into the future. Recent analysis of corporate financial disclosures found that only 5 to 10 per cent reported on long-term risks (Dupre et al., 2017)

Disclosure and climate preparedness in general will need to address this 'tragedy of the horizons' (Carney, 2015) by incorporating it into existing disclosure frameworks but also taking a longer-term perspective and as part of their overall strategic and risk management practices (TCFD, 2017).

On the investor side, academic literature raises questions about whether investors are sufficiently interested in the information provided by climate disclosure (Sullivan and Gouldson, 2012) and will meaningfully act on it such that it will affect share prices (Harmes 2011). While it remains to be seen how investors and financial markets will start pricing in climate change risk once disclosure becomes more mainstream, disclosure alone will probably not be sufficient without a supportive policy environment in general, including carbon pricing and support for renewables (Hamilton, 2009).

### **The Government has said it will 'encourage' publicly-listed companies to adopt the TCFD's recommendations on climate risk disclosure. How could it do this? Is a voluntary approach sufficient?**

**Response:** Disclosure needs to be consistent, relevant and widespread across companies, which will likely require making these disclosures a mandatory part of existing financial disclosure rules. The academic literature suggests that voluntary reporting alone may not be enough because companies do not have a sufficient incentive to disclose comparable and reliable data for users (Andrew and Cortese, 2011; Sullivan and Gouldson, 2012).

The academic literature is backed up by industry surveys that suggest that existing voluntary disclosures are inconsistent and incomplete (CDSB, 2016; Weber et al., 2017). A recent survey by HSBC shows that two-thirds of institutional investors are planning to increase their climate-friendly investments but lack appropriate information to do so (Ward, 2017).

Grantham Research Institute analysis for the Transition Pathway Initiative has also shown a great deal of variability within sectors in how they report on carbon emissions. For example, cement producers have created the Cement Sustainability Initiative voluntary reporting guidelines, but these are followed by only 10 out of the 19 largest cement producers (Dietz, French et al., 2017). Many other sectors lack voluntary guidelines in general, resulting in heterogeneous reporting of carbon intensities (Dietz, Garcia-Manas et al., 2017).

The considerable heterogeneity in what companies report and how this is integrated into principal risks and key performance indicators (CDSB, 2016) suggests that guidelines could be further refined to encourage more uniform and useful disclosure, and that the focus should be not only on encouraging disclosure but also making sure that it is useful. The Grantham Research Institute has addressed this topic in more detail in response to the Government's consultation on streamlined carbon reporting (Dietz, Matikainen et al., 2017).

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