

# Financial services and net zero: Seizing the opportunity

BRIEFING PAPER

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This briefing note explores the role of financial services in decarbonising the British economy. It also looks at the potential exports and jobs opportunities that could arise from the UK capitalising on its comparative advantage in green financial services. Lastly, we explore the role of policy in ensuring that these economic benefits are maximised, and that financial services can deliver on providing the capital needed for British industries to reach net zero.

## KEY POINTS

- **A high share of “green jobs” are – and will be – in the professional services sector.** New estimates presented here show that about 730,000 workers in professional, scientific, and technical services activities are in green jobs, as well as 200,000 workers in the finance and insurance sector. Combined, these industries currently account for about a fifth of all green jobs on our definition.
- **These industries also have a greater share of the workforce in green jobs than the economy average.** The latest ONS data show 27% of professional, scientific, and technical services workers in green jobs and 19% of financial services workers, compared with a UK-wide figure of 16%. While the financial services sector was broadly in line with the economy average share of green jobs in 2009, it is now ahead of the average.
- **Net zero finance has the potential to become one of the UK’s most successful green exports.** London is currently rated number one globally for the quality and depth of its green finance offerings, and low-carbon finance is expected to grow faster than all other low-carbon sub-sectors of the economy.
- **Financial services will be pivotal in providing other sectors of the economy with the capital needed to support green investments – mobilising private wealth, including pension wealth, to support these projects.** While around £800bn worth of UK pensions schemes are working aligned with net zero, most pension schemes (70%), worth £2 trillion, are yet to make net zero commitments and deploy capital in projects net zero-related – suggesting significant potential waiting to be untapped through a combination of government policy and financial services innovation.
- **Financial innovations are helping organisations – and countries – deliver on and commit to net zero.** This includes through relatively new sustainability-linked bonds, where bond issuers face a financial penalty if they fail to meet sustainability targets. March 2022 saw Chile issue the world’s first sovereign sustainability-linked bond, which is listed on the London Stock Exchange’s International Securities Market and Sustainable Bond Market.

## MAXIMISING THE ROLE OF FINANCIAL SERVICES IN DELIVERING NET ZERO

In our view, some particularly important next steps for policymakers include:

- **Creating the right fiscal and financial incentives for pension schemes to invest in green infrastructure.** Policymakers must take regulatory steps to empower UK pension funds to invest more in illiquid assets such as green infrastructure and real estate. The seven largest pension markets globally allocate on average 26% to illiquid assets – up from 7% in 2000. In contrast and disappointingly, the UK has remained flat in this period, with pension funds currently allocating just 8% to illiquid assets.
- **Fostering partnerships between financial services and leading educational institutions.** For the innovation phase in hydrogen or new energy technologies, the UK needs business accelerators and centres of excellence backed by leading universities – helping companies to develop the needed business models and proofs of concepts to gain financial backing.

Further, there is evidence that at present there is a shortage of finance professionals with sustainability-related skills; partnerships with leading educational institutions will be needed to address this gap.

- **Ensuring a sound carbon tax framework aligned with net-zero targets.** There is a direct mathematical relationship between carbon taxes and decarbonisation in investment portfolios. Despite this, Britain currently has an “inconsistent hodgepodge of different taxes, subsidies and regulations” that has left the businesses and households facing multiple different carbon prices.

A more consistent, fairer approach to carbon taxation would ensure that the value of assets better reflects their sustainability, creating stronger incentives for companies to decarbonise and investors to rebalance their portfolios towards greener opportunities. Singapore’s recent moves on carbon taxation, mentioned earlier, may provide a lesson for the UK.

- **Government leading the charge on sustainability-linked bonds and making the UK the global centre of sustainability-linked finance.** Lastly, the government should continue to be at or near the front of the pack in embracing innovative forms of green finance – spurring others to take action and strengthening the UK’s position as a cutting-edge financial centre.

With this in mind, the Chancellor should explore issuing sustainability-linked Bonds, tied to the UK’s targets on net zero. As well as creating a commitment device for the government to decarbonise Britain, it could help secure the UK as a leading hub of sustainability-linked finance.

## GREEN JOBS IN FINANCIAL AND PROFESSIONAL SERVICES

Much of the public debate around “green jobs” and achieving net zero has focused on those likely to be generated in the manufacturing and construction sectors – for example, in producing electric vehicles, installing heat pumps and wind turbines, and insulating homes.

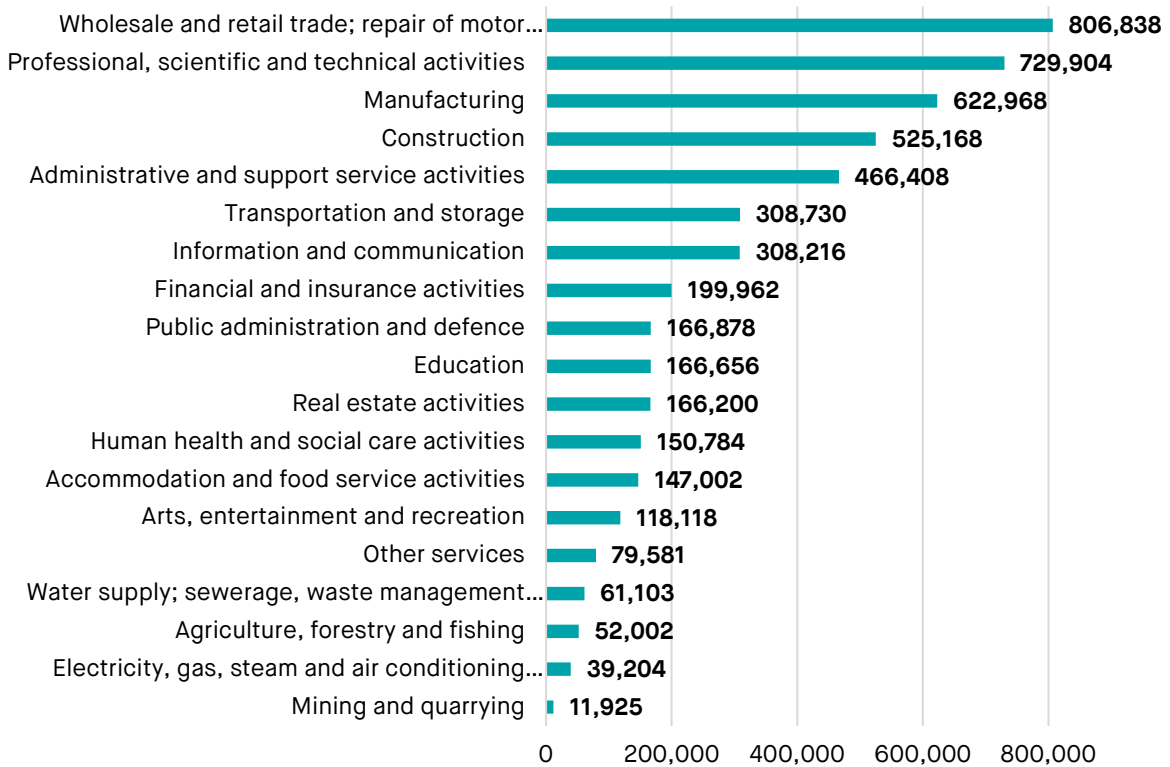
However, while these jobs will be crucial for reaching net zero – and are of great interest to the SMF<sup>1</sup> – it is vital that policymakers do not overlook the role of services in decarbonising Britain. From consultancy firms advising companies looking to reduce their carbon footprint, to banks and asset managers providing the capital needed to invest in green infrastructure, service-based occupations will be critical if we are to get to where we need to be. Services – particularly financial services – also provide some of the most promising green export opportunities for Britain.

### **Financial and professional services are increasingly focusing on decarbonisation, accounting for a high share of green jobs**

New SMF calculations presented here explore the number of workers in different industries that are devoting a significant proportion of their time (>20%) to green tasks – what we will call henceforth “green jobs”. Green tasks span a wide range of areas<sup>2</sup>, from constructing green infrastructure, to – in the case of services – financial analyses of green investments, determining the best way to market new green products, and developing systems for collecting, analysing and interpreting environmental data.

Across Britain, 5.1 million workers are in green jobs on this definition – 16% of the total workforce. This includes about 730,000 workers in professional, scientific and technical services activities, and 200,000 workers in the finance and insurance sector. Combined, these industries currently account for about a fifth of all green jobs.

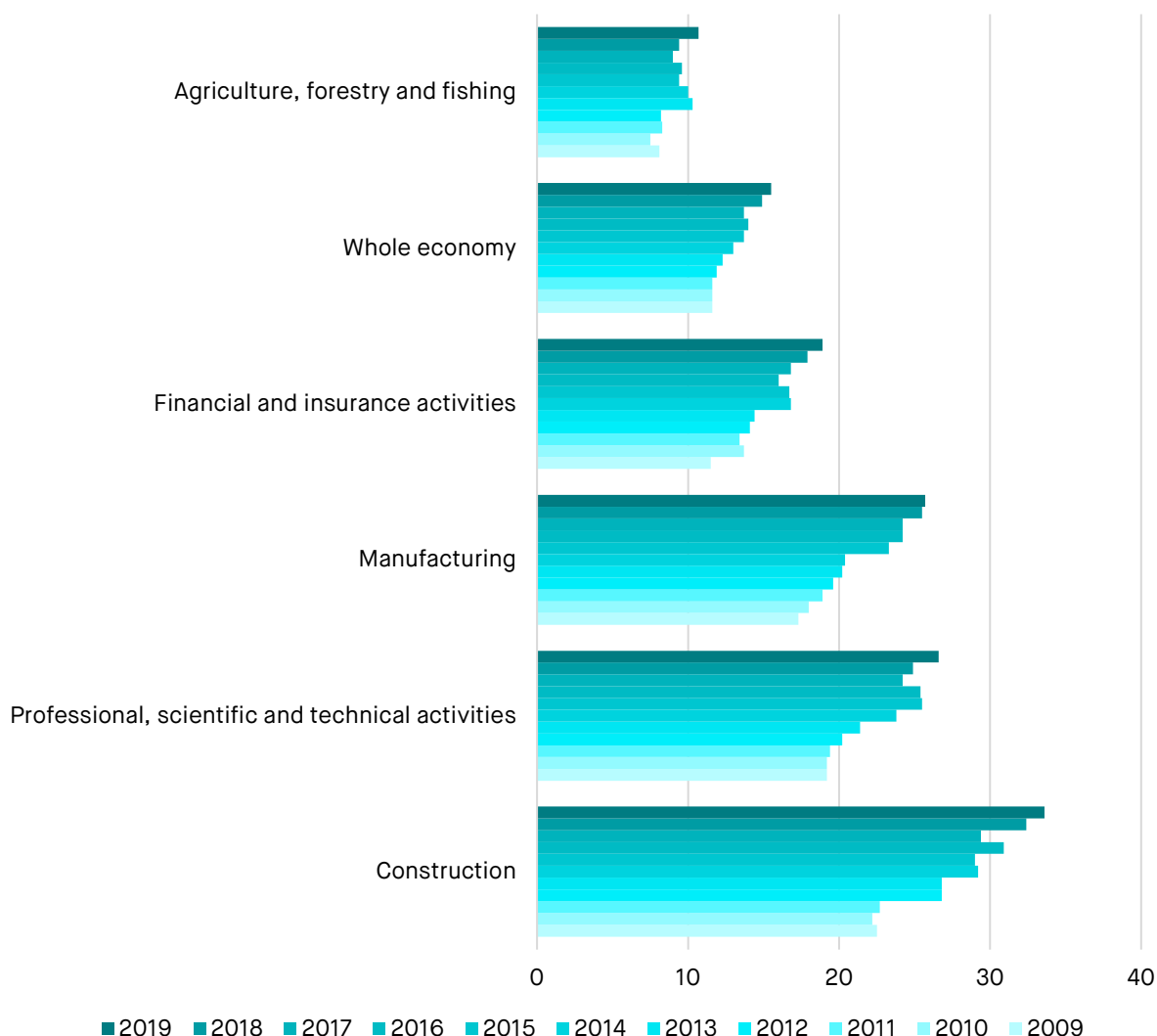
**Figure 1: Number of green jobs by industry, 2019. Green jobs defined as those where >20% of time is spent on green tasks**



Source: SMF calculations based on ONS estimates of time spent doing green tasks<sup>3</sup> and Business Register and Employment Survey

These industries also have a greater share of the workforce in green jobs, than the economy average. The latest ONS data show 27% of professional, scientific, and technical services workers are in green jobs – this is the case for 19% of financial services workers, compared with a UK-wide figure of 16%. Further, as the following chart shows, these shares have increased significantly over the past decade. While the financial services sector was broadly in line with the economy average share of green jobs in 2009, it is now ahead of the average.

**Figure 2: Proportion of jobs, for selected industries, where >20% of time is spent on green tasks, %**

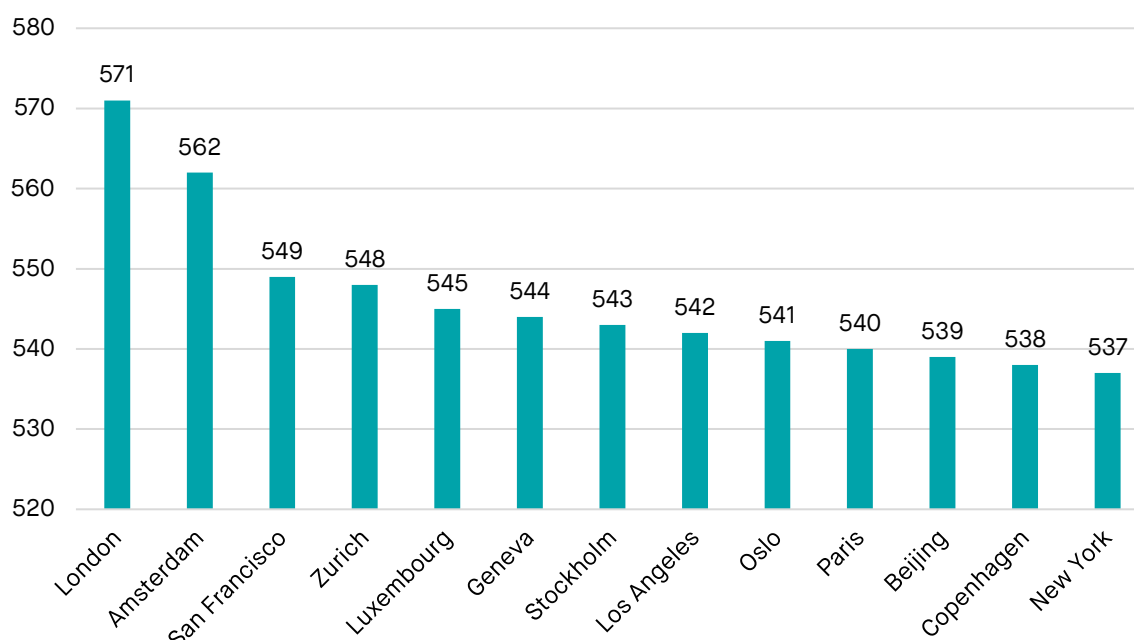


Source: ONS estimates of time spent doing green tasks<sup>4</sup>

## BRITAIN MUST LEVERAGE ITS COMPARATIVE ADVANTAGE IN GREEN FINANCE

The increasing focus of professional services workers on net zero is not a mere burden – but a substantial economic opportunity for the UK which can create and support thousands of well-paying jobs. Done right, there is scope for businesses and government to leverage Britain’s comparative advantage in high value-added services to generate exports of these services to other markets.

The UK is particularly well-placed in green finance. It has been estimated that low carbon financial services could generate an export opportunity of up to £7.5bn per year in 2030, rising to £17bn per year by 2050<sup>5</sup>. Indeed, this is an area of net zero where Britain can truly become the world-leader; the latest Global Green Finance Index<sup>6</sup> produced by Z/Yen saw London come out top for the quality and depth of its green finance offerings, overtaking Amsterdam.

**Figure 3: Global Green Finance Index score**

Source: Z/Yen

And, beyond exports, there is also strong *domestic* appetite for financial services that deliver on net zero. For example, just under half of UK pension holders would switch to a green pension if offered one by their provider<sup>7</sup>. Local government, including the Greater London Authority<sup>8</sup>, is looking to “green bonds” as a way of securing investment in climate action. Green bonds are bonds that are specifically earmarked to raise money for climate and environmental projects.

A report last year<sup>9</sup> from Kmatrix forecasted that the carbon finance sub-sector will see the fastest growth of all low-carbon sub-sectors of the economy, with annual sales growth rising from 7.8% in 2021/22 to 14.4% in 2025/26. These growth rates are about double the 3.7% and 6.7% expected for low-carbon sub-sectors as a whole for these years, respectively, reflecting the UK’s relative strength in this area.

## THE ROLE OF FINANCIAL SERVICES IN UNLOCKING GREEN INFRASTRUCTURE

Financial services will be pivotal in providing other sectors of the economy with the capital needed to support green investments – by mobilising private wealth, including pension wealth, to support these projects.

The sums of money that could be unlocked are enormous. For example, while around £800bn worth of UK pensions schemes are working aligned with net zero<sup>10</sup>, most pension schemes (70%), worth £2 trillion, are yet to make net zero commitments and deploy capital in net zero-related projects – suggesting significant potential waiting to be untapped through a combination of government policy and financial services innovation.

What investors, wealth managers, and pension funds need is a pipeline of concrete projects and an assessment of risks and expected returns. Current regulatory capital requirements for banks with Basel III, and Basel IV coming up, and the implementation of IFRS9<sup>11</sup> have reshaped the way to finance these investments, and banks alone cannot afford to do this. The Basel Committee's implementation date for Basel IV is 1 January 2025 and includes new standards for credit risk, operational risk and credit valuation adjustments. It means higher regulatory capital requirements for banks<sup>12</sup>.

Given this, specialised asset managers have emerged and are emerging to tackle green infrastructure and energy investments. There is an opportunity for banks to be advisors and arrangers and provide the trustworthy market infrastructure required to develop carbon markets platforms that will help in the decarbonization and energy transition.

Carbon finance markets and carbon credits will also play a key role in decarbonising high CO<sub>2</sub>-emitting industries and providing transition finance, ultimately giving room to incorporate emerging low CO<sub>2</sub> technologies. It requires a clear policy framework for carbon taxes, like the one launched in Singapore in February<sup>13</sup>, to provide a price signal for carbon credits to allow decarbonisation across industries and emerging energy technologies.

Another innovation, building on green bonds, is “sustainability-linked bonds” – such as key performance indicator (KPI)-linked or Sustainable-Development-Goal (SDG)-linked Bonds – which can support the financing of investment in green infrastructure. SDG-linked bonds are structurally linked through a covenant linking the coupon of a bond to the issuer's achievement of decarbonisation or SDG goals. This is part of the financial innovation in green finance that does not compromise the banks' balance sheets and helps all financial intermediaries, including pension funds and wealth managers to more easily find investment opportunities.

The first SDG-linked bond in the world<sup>14</sup> was issued by Italian power utility company Enel in September 2019. It targeted a 55% share of renewables in its power generation capacity by the end of 2021, with a 25-basis points step-up in case of failure – implying higher borrowing costs (a financial penalty) for failing to meet the sustainability target. Enel also linked the target to executive remuneration.

## WHERE NEXT FOR POLICY?

Mobilising private wealth will be crucial for financing investment in green infrastructure – by both government and private enterprise. However, the financial services sector cannot deliver in isolation; it requires government policy support, tax incentives, credit enhancement mechanisms to unlock capital, and UK government allocation of capital for equity and debt funds as an anchor investor.

In our view, some particularly important next steps for policymakers include:

## **1. Creating the right fiscal and financial incentives for pension schemes to invest sustainably**

Policymakers must take regulatory steps to empower UK pension funds to invest more in illiquid assets, such as green infrastructure and real estate. The seven largest pension markets globally allocate on average 26% to illiquid assets – up from 7% in 2000. In contrast and disappointingly, the UK has remained flat in this period, with pension funds currently allocating just 8% to illiquids.

Given this, it is welcome that Government is currently consulting on facilitating investment in illiquid assets by defined contribution (DC) pension schemes<sup>15</sup>. The new consultation includes amendments to the statement of investment principles that would require DC schemes with more than £100m in assets to disclose and explain their policies on illiquid investments. The consultation also notes that the Government is continuing to consider whether to exclude (some) performance fees from the pension charge cap. Excluding performance fees from the charge cap of 0.75% is seen as a way of encouraging defined contribution schemes to invest in illiquid assets since these assets often use these fees.

Other barriers to pension fund investment in green (and indeed non-green) infrastructure and real estate, which need to be addressed include trustee reluctance, governance requirements, and lack of supply for investment platform users<sup>16</sup>.

## **2. Fostering partnerships between financial services and leading educational institutions**

Developing the innovation required in capital-intensive new technologies – such as green hydrogen and small modular nuclear reactors – requires mobilising equity funds along with bridge debt funds for the construction phase, and ultimately requires key incentives to build up the business model with specialised investors.

For the innovation phase in hydrogen or new energy technologies, the UK needs business accelerators and centres of excellence backed by leading universities – helping companies to develop the needed business models, understanding of risks and opportunities, and proofs of concepts.

Scotland's Hydrogen Accelerator<sup>17</sup> – a partnership between the University of St Andrews and the University of Strathclyde launched in 2020 – is a good example of this. The Hydrogen Accelerator will assist companies throughout the hydrogen supply chain from fuel cell manufacturers to energy specialists, providing access to specialised manufacturing and testing equipment, and a knowledge exchange programme informing companies of recent advances in energy storage technologies. The accelerator will also identify innovation opportunities and provide advice around growth opportunities including relevant funding calls.

Another example of effective partnership working between universities and enterprise is the Centre for Climate Finance and Investment (CCFI) at Imperial College Business School. The CCFI undertakes research on how capital markets are responding to global



climate change, helping investors and policymakers overcome the lack of clarity about risks and opportunities arising in a changing climate<sup>18</sup>.

Imperial College is also partnering with the University of Oxford-led UK Centre for Greening Finance & Investment (CGFI), alongside the Universities of Bristol, Leeds and Reading.<sup>19</sup> Further, working internationally, Imperial College Business School has set up the Singapore Green Finance Centre with Singapore Management University, backed by the Monetary Authority of Singapore and leading global financial institutions.<sup>20</sup>

The financial services sector has a key role to play in the systemic transition to a sustainable low carbon economy and will create thousands of jobs. However, it requires education to equip British financial professionals and senior management with a complete set of skills, knowledge, values, understanding and strategic insights to help their transition.

There is evidence that, at present, there is a shortage of finance professionals with sustainability-related skills; a recent review by the CFA Institute of more than 10,000 investment professional jobs posted on LinkedIn found 6% mention such skills. However, an analysis of the LinkedIn profiles of around one million investment professionals found that only 1% referenced sustainability skills<sup>21</sup>. Partnerships with leading educational institutions will be needed to address this gap.

### **3. Ensuring the true price of carbon is reflected in investment decisions**

There is a direct mathematical relationship between carbon taxes and decarbonisation in investment portfolios<sup>22</sup>, and innovative net-zero asset managers incorporate carbon taxes in their strategic asset allocation.

Despite this, Britain currently has an “inconsistent hodgepodge of different taxes, subsidies and regulations”<sup>23</sup> that has left the businesses and households facing multiple different carbon prices.

For example, while rail and road transport face relatively high effective carbon taxes, carbon emissions from aviation are effectively subsidised by the government due to the lack of VAT on air tickets<sup>24</sup>. Carbon emissions from the agricultural sector are also subsidised by the government.

A more consistent, fairer approach to carbon taxation would ensure that the value of assets better reflects their sustainability, creating stronger incentives for companies to decarbonise and investors to rebalance their portfolios towards greener opportunities. Singapore’s recent moves on carbon taxation, mentioned earlier, may provide a lesson for the UK.

Britain launched its own Emissions Trading Scheme (ETS) on 1 January 2021<sup>25</sup> as a direct effect of leaving the EU’s ETS. ETSs generally work on the ‘cap and trade’ principle, where a cap is set on the total amount of certain greenhouse gases that can be emitted by sectors covered by the scheme. Participants receive free allowances and/or buy emission allowances at auction or on the secondary market which they can trade with other participants as needed.

In partnership with policymakers, British accounting bodies must tackle the accounting issues related to carbon offsets and carbon credits accounting. Further, industry and government can build up the market infrastructure required for the efficiency of carbon markets, taking advantage of Britain's sound financial centre and the wide range of banks headquartered here. There is currently the Carbonplace initiative being developed by a group of financial institutions, aiming to provide a settlement platform to facilitate secure and scalable trading of high-integrity carbon credits<sup>26</sup>.

#### **4. Government leading the charge on sustainability-linked bonds and making the UK the global centre of sustainability-linked finance**

Lastly, the Government should continue to be at or near the front of the pack in embracing innovative forms of green finance – spurring others to take action and strengthening the UK's position as a cutting-edge financial centre. The Chancellor, Rishi Sunak, set out the Government's ambition for the UK to be the world's first net zero-aligned financial centre<sup>27</sup>.

The Chancellor has already taken steps with the issuance of the UK's first green gilts<sup>28</sup>. But why stop there? We noted earlier that sustainability-linked bonds are emerging as a new way of holding organisations to account on net zero, with financial penalties for firms (and greater financial returns for investors) if a company fails to meet its sustainability goals. Why not bring the same principle to government?

It turns out you can: March 2022 saw Chile issue the world's first sovereign sustainability-linked bond<sup>29</sup>, which is listed on the London Stock Exchange's International Securities Market and Sustainable Bond Market<sup>30</sup>.

The \$2bn (around £1.5bn) sustainability-linked bond was issued on 2nd March. Demand for the bond reached more than \$8bn (£6bn), or 4.1 times the original placed amount, spread across investors in Europe, Asia and the Americas. The bond adheres to the Paris Accord on climate change, including that the country emits no more than 95 metric tons of carbon dioxide and equivalent by 2030, and that 60% of electricity production must be derived from renewable energy by 2032.

It was issued under Chile's recently published Sustainability-Linked Bond Framework, which outlines the Key Performance Indicators being tracked to measure Chile's performance towards its defined Sustainability Performance Targets. If Chile misses a target, it incurs a financial penalty with a step-up in the bond's coupon rate<sup>31</sup>.

If this Government really wants to show that it is fully committed to decarbonisation, it should issue an sustainability-linked gilt. The prospect of financial penalties for overpromising and underdelivering could prove a powerful way of holding the government true to its word on net zero.

## ABOUT THE AUTHORS

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## ENDNOTES

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<sup>3</sup>

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<sup>4</sup>

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<sup>5</sup> <https://www.theccc.org.uk/wp-content/uploads/2017/03/ED10039-CCC-UK-Bus-Opportunities-Draft-Final-Report-V7.pdf>

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