

UCL IIPP calls on world leaders to rethink the role of finance at COP27

To deliver a just transition to net zero, states must go beyond market-fixing and de-risking and embrace their role as market shapers.

In the 12 months since world leaders gathered in Glasgow for COP26, the task of financing global decarbonisation has become even more urgent. Our reliance on volatile fossil fuels has once again left households and businesses at the mercy of soaring inflation, while fossil fuel producers enjoy [record profits](#). In response, central banks have hiked interest rates to the highest levels in over a decade, while at the same time warning of impending recession.

Not only will higher interest rates do little to mitigate the underlying drivers of [‘fossilflation’](#), they also threaten to derail the global energy transition. It is estimated that clean energy-related investment needs to reach [\\$4 trillion annually by 2030](#) to achieve net zero by 2050, up from around \$1 trillion now. However, clean investments are more capital intensive than fossil fuel investments, and are therefore more sensitive to interest rate rises. At a time when scaling up renewable energy is more important than ever, there is a risk that tighter monetary policy will result in destructive [‘green collateral damage’](#).

The forthcoming COP27 summit therefore represents a critical juncture for the financing of global climate commitments. At the heart of these discussions lies a vital question: who is going to finance decarbonisation on the scale and pace that is required?

At COP26, the dominant narrative that emerged was that private financial institutions can lead in funding the transition to net zero. The Glasgow Financial Alliance on Net Zero (GFANZ) – a group of 450 private financial institutions – announced that its members have up to \$130 trillion in funding ready “at their disposal” to tackle the climate crisis.

But if private finance has the means to fund the green transition many times over, why hasn’t it happened yet? The answer is twofold.

Firstly, the claim that there is \$130 trillion of private finance waiting to be deployed [was a significant misrepresentation](#). The \$130 trillion refers to total assets currently under management, not funds ready to be committed. Most importantly however, many of the required investments do not yet satisfy the risk-return preferences of commercial investors. For profit-maximising financial institutions, green investments that are long-term, high-risk and promise uncertain returns are not seen as a strategic priority. For the time being, it still makes financial sense to channel billions of dollars per year into fossil fuels and other dirty activities. In recent weeks

numerous members of the GFANZ [have left the alliance](#) due to concerns about the cost associated with monitoring and reporting against the commitments.

That state support is required to redirect investment from dirty sectors into green activities is not in any doubt. The key question is: what role do states need to play to mobilise investment at the scale and pace required?

The prevailing consensus, which we believe is insufficient, holds that state support should [primarily take two forms](#). Firstly, states should employ 'market fixing' strategies to enhance price discovery. The goal is to improve the clarity of climate-related information, and to encourage the inclusion of climate-related financial risks into market pricing. Many central banks have already begun to incorporate private-sector led climate risk disclosure initiatives into supervisory expectations.

Secondly, states should embrace a 'de-risking' role to correct price signals. Examples of this include central bank interventions to change the relative price of 'green' and 'dirty' financial assets, and government and development bank initiatives to socialise risks associated with private green investments (for example through 'first-loss' instruments, guarantees and 'blended finance'). In each case the aim is to recalibrate the risk-return profile on green investments to make them more commercially attractive.

Although this represents an important step towards decarbonisation, by itself it is unlikely to succeed. One reason for this relates to the underlying assumptions. It is assumed that climate-related risks are measurable, and that private actors will act on disclosures in their financing decisions. In reality however, the physical and transition risks related to climate change and other environmental threats are subject to [radical uncertainty](#) and complex [non-linear dynamics](#) that cannot be reliably internalised into market prices. In addition, given that prominent green asset classes and risk frameworks have been developed by coalitions of financial firms acting through non-profit entities, there is a significant risk of regulatory capture and ['greenwashing'](#).

Relying on enhanced price discovery and price signals is also unlikely to fuel green innovation on the scale required. The market-led, risk-based approach is rooted in the belief that private financial institutions are more effective at allocating capital, and that states should avoid pursuing policies that try to 'pick winners' or 'distort' market competition. However, the recent history of capitalism tells a different story, one in which different types of public actors have been responsible for actively shaping and creating markets, not just fixing them. Throughout history many major technological breakthroughs were only made possible by public entities that were willing and able to take risks before the private sector was. Here, the story is not one of the state getting out of the way, but of an ['entrepreneurial state'](#) that is a lead investor and risk-taker, co-creating and shaping new markets, not simply 'fixing' them.

Perhaps most fundamentally however, the private finance-led approach seems at odds with the goal of delivering a global just transition, where costs and risks are shared fairly both within and between nations. In practice, de-risking involves transferring risks from private investors towards public balance sheets while leaving financial returns fully privatised. In order to satisfy the demand for these returns, climate-related investments are required to generate steady cash flows, which often necessitates the introduction of user charges or government fees. Building on initiatives such as the [World Bank's 'Maximizing Finance for Development' and the G20's 'Infrastructure as an Asset Class'](#), the emerging consensus aims to use de-risking instruments to turn green physical and social infrastructure, and [more recently in nature](#), into investable 'asset classes'.

However, evidence shows that using de-risked private finance is often [more risky and expensive](#) for governments and/or users. It also perpetuates a system where money flows upwards from debtor to creditor – and from Global South to Global North. Many of these investments have essential public good characteristics that could be more effectively funded through direct fiscal spending.

None of this is to say that private finance does not have a crucial role to play in the green transition. But mobilising investment on the scale required to decarbonise the global economy requires a bolder approach. What should this look like?

Firstly, it means states must embrace their role as financial market shapers, not just market fixers. With regards to private finance, this means creating a strong regulatory framework to direct private investment away from dirty sectors into green activities. This could include central banks introducing [allocative green credit policy regimes](#) that are organised around green industrial policy objectives and democratically agreed green missions. It also means introducing stronger regulations to prevent greenwashing and prevent large non-bank financial institutions from engaging in regulatory arbitrage.

Second, states should embrace their role as 'investor of first resort', not just 'lender of last resort'. Around the world public financial institutions – including multilateral development banks, national investment banks and state level banks – deploy many billions of dollars of capital each year. Because of their distinct design and governance features, they are able to supply the kind of long-term, patient, strategic finance that the private sector is often unwilling to provide. In recent years there have been [growing calls](#) for public financial institutions to retreat from direct lending in favour of providing de-risking instruments to 'unlock' private sector investment. This is deeply misguided: [evidence shows](#) that direct lending from well governed public banks can play a [powerful market shaping role](#) promoting structural change and crowding-in private investment.

Thirdly, it means rethinking the relationships and contracts between the public and private sectors to better align the sharing of risks and rewards. Where public entities are bearing risks to support public purposes, they should also be able to share in the associated rewards. This can be done via mechanisms to share financial returns, for example by taking public equity stakes in major renewable energy projects and other green investments. However, states can also aim to capture social returns, for example by attaching conditions regarding market access, retail pricing or the intellectual property (IP) rights over products and services that have benefited from state financial support.

Fourthly, it means recognising that debt finance – whether provided by the public sector or the private sector – is not necessarily an appropriate substitute for direct fiscal spending. The logic of repayable financial instruments is not easily reconciled to the public good characteristics of some climate-related investments, such as forest restoration. Strategic coordination between [fiscal, monetary and industrial policy](#) is therefore needed on a much larger scale to deliver the investment needed, and to ensure that costs and risks are shared in a just manner. Financial regulation and monetary policy must also be aligned with this approach to ensure that private finance does not undermine or subvert the actions of nation-states.

Finally, it means ensuring sufficient fiscal space for countries in the Global South to pursue domestic decarbonisation and adaptation agendas. Many countries, including those that are most exposed to accelerating climate breakdown, face significant debt overhangs, and this has been exacerbated by an international trade and monetary system that is rigged against them. As a result, it is imperative that debtor countries in the Global North, which are responsible for the majority of historic carbon emissions, free up fiscal space for creditor countries in the Global South. This should include historic debt write-offs, debt restructuring, replacing climate loans with non-repayable grants, and paying compensation for loss and damages.