Briefing: Green Reform of the Bank of England

24th May 2018

Summary of key points

- **The Bank of England could play a pivotal role in raising green investment in the UK.** A more active climate role for the Bank would also help **reduce the extent of climate-related risk in the financial system**, including systemic risk from high-carbon stranded assets.
- **Several policies are available to central banks** to raise public and private green investment and alleviate climate-related financial risk**.** These include purchasing green bonds, or financing deficit spending by the government on green infrastructure.
- To empower the Bank to have a beneficial impact on the environment, it **needs reform to its mandate**. This could occur in the form of a review of the monetary policy framework by BEIS and the Treasury, while the Chancellor of the Exchequer could alter the remit for the Monetary Policy Committee to require that it take account of climate sustainability in its decisions.

Why should climate change concern the central bank?

Two arguments support the view that central banks should use proactive policies to help align the economy and financial system with the low-carbon transition:

- Firstly, finance faces systemic risk both from the physical damage caused by a changing climate and from changes in policy, technology and market structure associated with the transition itself. Given that many central banks, including the Bank of England, have a mandate to safeguard financial stability, climate change affects their duties.

- Secondly, trillions of pounds of investment are needed globally to fund the low-carbon alternative. In the UK, the political structure recognises the urgency of climate change in the form of legally binding targets for reductions in greenhouse gas emissions. At the start of 2018, the government remained behind on meeting these targets.[1] Moreover, MPs on the Environmental Audit Committee have recently identified a 'collapse' in new clean energy investment in the UK, which fell by 56% in cash terms in 2017.[2]

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[1] Committee on Climate Change (2018). *An independent assessment of the UK's Clean Growth Strategy: From ambition to action*. January, p. 14

[2] Environmental Audit Committee (2018). *Green finance: mobilising investment in clean energy and sustainable development*. House of Commons, May 16

What policies could the Bank use?

There are three main areas where the central bank could intervene. They include guiding and structuring the market for green finance, applying macroprudential regulation to lending on the basis of climate risk, and deploying monetary policy to support green public and private investment.

Structuring green finance markets

The Bank should publish its own green lending guidelines for commercial banks to ensure the UK's growing green finance offering brings genuine environmental benefits.

Secondly, as a financial institution serving the public interest, the central bank should lead by example on disclosure of climate-related financial risk. So far the Bank has yet to follow the same logic it has publicly endorsed in the form of the recommendations made by the Taskforce for Climate-Related Financial Disclosures. Evidence on its Corporate Bond Purchase Scheme, part of quantitative easing (QE), suggests that its investments are far from sustainable, instead being skewed towards high-carbon sectors.[3] **The Bank should disclose the climate risk of the assets on its balance sheet – including those purchased through QE and all the investments it makes through its regular operations.**

Green financial regulation

Since high-carbon assets present a potential build-up of *systemic* risk to finance and the economy, regulators should take a macroprudential perspective. The Bank of England can monitor and assess the level of climate risk system-wide through the Prudential Regulation Authority, which has already reviewed climate risk in the banking and insurance sectors. To shift bank lending away from systemically risky high-carbon projects, the Bank could consider imposing higher capital requirements on such projects than on comparable lower-carbon loans.

Before adopting such a policy, new tools are needed to measure and assess systemic risk, as conventional stress tests are not appropriate. The **Financial Policy Committee should use its authority to promote work at the Bank on macroprudential risk-assessment tools to measure and regulate the climate risk companies and investors are exposed to**.

Green monetary policy

Unconventional monetary policy to date has done little to further climate change objectives and sits at odds with the Bank of England's own concern for financial stability and climate risk, given that it has unintentionally promoted high-carbon sectors. Yet monetary policy tools, especially in a recession, could have significant environmental benefits.

Under any further use of QE, **the Bank could prioritise purchasing green assets by screening corporate bonds for their carbon intensity and corresponding climate risk**. It could also **make**

[3] Matikainen, S., Campiglio, E., and Zenghelis, D. (2017). *The climate impact of quantitative easing*. Grantham Research Institute on Climate Change and the Environment, May

large-scale purchases on the secondary market of green sovereign bonds issued by the UK government, were the government to issue them (as the Green Finance Taskforce recommended in its final report from March this year)[4]. A final option is for the Bank to conduct overt monetary financing of deficit spending by the government on green infrastructure, which would be especially useful to stimulate demand in a recession. Power over the destination of newly-created money would remain in the hands of government, preserving democratic control over spending.

How reform of the Bank of England's mandate could accelerate progress

To use these tools, the Monetary Policy Committee (MPC) and Financial Policy Committee (FPC) need their remits to reflect the importance of environmental sustainability to the viability of the economy and the financial system.

The Chancellor of the Exchequer writes a letter, typically annually, to the Bank with the remit and recommendations for the FPC. The letter can draw attention to 'responsibilities in relation to support for the government's economic policy, as well as matters to which the Committee should have regard in exercising its functions.'[5] This is a power granted to the Treasury by the 2012 Financial Services Act. **This letter could make explicit reference to climate risk, in order to catalyse action now to prevent potentially system-wide losses in the future**.

The Treasury carried out a review of the 'monetary policy framework' in 2013, announced by the Chancellor in the Budget that year and justified by reference to the recent financial crisis. The impending climate crisis warrants a new approach. The arguments made in section 4.3 imply that a repeat review of the framework would be a crucial first step to green reform. **In conjunction with the Department for Business, Energy and Industrial Strategy, the Treasury should conduct a fresh review of the monetary policy framework with respect to the impact of climate change on the UK economy** and consider changes to the remit for the MPC.

The Chancellor, taking into account the conclusions of a review of the framework, **could update the remit for the MPC to require that its decisions take account of and communicate the links and potential trade-offs between climate sustainability and price stability**.

Recommendations:

The Bank of England should:

- publish its own green lending guidelines for commercial banks;
- disclose the carbon risk of the assets on its own balance sheet and exhibit best practice in terms of disclosure for financial companies;
- no longer buy bonds issued by fossil fuel companies;

[4] Green Finance Taskforce (2018). *Accelerating Green Finance*. March
[5] Hammond, P. (2017). 'Recommendations to the Financial Policy Committee: Spring Budget 2017'. Letter to the Governor of the Bank of England, March 8

- produce open and transparent research into how unconventional monetary policy might interact with the need for green and sustainable investment in the UK.

To enable bolder policies:

- the Treasury, in concert with the Department for Business, Energy and Industrial Strategy, should conduct a fresh review of the monetary policy framework with respect to the impact of climate change on the UK economy and consider changes to the remit for the MPC;
- considering such a review, the Chancellor of the Exchequer should update the remit for the MPC to require that its decisions take account of and communicate the links and potential trade-offs between climate sustainability and price stability;
- recommendations made as part of the remit for the FPC should refer to 'environmental sustainability' under the heading of 'matters that the Financial Policy Committee should regard as relevant to the Bank's financial stability objective.

For more information or to arrange a meeting to discuss the issues in this briefing, please contact:

Rob Macquarie | robert.macquarie@positivemoney.org.uk | 0207 253 3235