Why the Bank of England's monetary policy framework should incorporate climate risk

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Summary of key points

- While the Bank of England has stated that climate change represents a significant source of risk to the financial system, and has pressed the firms it supervises to consider how to manage those risks, its own policy framework is inconsistent with that recognition
- Monetary policy operations - including both the Bank's collateral frameworks and the criteria for its asset purchases under the quantitative easing programme - fail to reflect the reality of climate-related risk
- The Bank should lead by example and make a visible move towards incorporating measures of climate risk into its collateral framework and asset purchase criteria. It should also disclose an assessment of the climate risk it is exposed to through the assets it owns

Why does climate change concern the Bank of England?

Finance faces significant risks both from the physical damage caused by a changing climate and from changes in policy, technology and market structure associated with the transition itself.[1] For instance, British insurance firm Hiscox saw its pre-tax profits decline by over 90 per cent from 2016 to 2017 due to the high incidence of natural disasters in the latter year.[2] Fossil fuel assets may well become 'stranded' and lose their value,[3] hurting the value of relevant companies and creating losses in equity markets and on bank loans.

Feedback loops and second-order effects mean that the potential for systemic instability across the financial system and the wider economy is pronounced. The Network for Greening the Financial System (NGFS), of which the Bank of England is a founding

[1] Scott, M. *et al.* (2017). 'The Bank's of England's response to climate change'. *Bank of England Quarterly Bulletin*, Q2, pp. 98-109

[2] Ralph, O. (2018). 'Hiscox profits drop sharply after year of catastrophes'. *Financial Times*, February 26. Available at: https://www.ft.com/content/8183d90c-1ad9-11e8-aaca-4574d7dabfb6

[3] Mercure, J.-F. *et al*. (2018) 'Macroeconomic impact of stranded fossil fuel assets'. *Nature Climate Change*, 8, pp. 588–593

member, has argued that 'climate change will affect the global economy and so the financial system that supports it. The financial risks it presents are in consequence system-wide and potentially irreversible if not addressed.'[4]

The Bank of England, has issued draft expectations of firms it supervises through the Prudential Regulation Authority. They include recommendations to 'embed the consideration of the financial risks from climate change in their governance arrangements; **incorporate the financial risks from climate change into existing risk management practice;** and '**develop an approach to disclosure on the financial risks from climate change**.'

Bank policy on climate is incoherent

While the Bank of England has talked the talk, it hasn't walked the walk. The requirements for regulated firms clearly specify that financial organisations should guard against the level of climate risk they are exposed to. The Bank's own monetary operations fail to integrate these concerns, making the posture of its monetary policy incoherent with its regulatory activity.

Collateral frameworks dictate which assets banks are able to provide to the Bank of England in exchange for borrowing reserves (a crucial source of funding for the banks and the mainstay of the monetary policy transmission mechanism). The Bank of England defines a set of assets it considers safe enough to accept as collateral. Eligibility under the collateral framework bestows a significant advantage on the assets in question, as banks' demand for those assets increases. Investment in the respective areas of the economy that provide 'safe' assets can be expected to increase.[5] **The Bank of England must incorporate climate risk into its collateral framework, or else continue to subsidise risky, high-carbon sectors of the economy.**

Moreover, the Bank has yet to follow the same logic it has publicly endorsed on disclosure. Evidence on the Bank's Corporate Bond Purchase Scheme, part of quantitative easing (QE), suggests that its investments are far from sustainable, instead being skewed towards high-carbon sectors.[6] **The Bank should lead by example and 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.**

[4] *NGFS First Progress Report*, October 2018

[5] Nyborg, K. G. (2017). 'Central Bank Collateral Frameworks'. *Journal of Banking & Finance*, Vol. 76, March, pp. 198-214

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

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Recommended questions

The hearings for the November Inflation Report published by the Monetary Policy Committee are an opportunity to press Governor Mark Carney and the Bank's Deputy Governors on the Bank's wider approach to climate risk.

In particular, the Bank's policymakers need to answer:

- **Why has the Bank not made its monetary policy operations consistent with its understanding of climate-related financial risk?**
- **What steps is the Bank taking to ensure collateral frameworks and asset purchases incorporate climate-related risk and avoid subsidising climate-risky activity?**

For more information or to arrange a meeting to discuss how to progress with the issues in this briefing, please contact us at:

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